

Out of the shadow?

Accounting for Special Purpose Entities in European banking systems

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ABSTRACT

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This dissertation investigates the capacity of states to limit regulatory circumvention in financial markets. The recent financial crisis has confirmed the widespread abuse of regulatory frameworks by the banks to their advantage, testing the limit of the permitted.

The loophole behaviour of financial market actors, exploiting the rigidity of rules is unstoppable, given the impossibility to specify all possible events in rules. This essential fact of financial market regulation in itself is not the topic of this dissertation. The question instead is, given these conditions, how can state agencies limit this behaviour? By investigating the evolving regulatory treatment of a segment of the shadow banking sector driven by regulatory arbitrage in four different countries, this dissertation seeks to establish a comparative answer.

In the investigated case of off-balance sheet financing, regulatory arbitrage occurred at the overlap of banking regulation and accounting regulation, a strategic location chosen to escape regulation. Asset-Backed Commercial Paper conduits, the financial innovation studied were structured at the margins of existing accounting regulation to avoid on-balance sheet status. They were also structured to be at the margins of banking regulation, in order to avoid regulatory costs. As they were structured just outside the margins of global banking accords, they were forcing regulators to take a national regulatory stance in the regulation of a global market. These

constructs were “stitched on the edge” of existing regulation, always seeking to exploit weaknesses of regulation and of the gatekeepers seeking to enforce it. Auditors didn’t have a weapon against new constructs as the rules were missing and national regulators had difficulties dealing with these new constructs because they were not regulated globally. The “cutting edge” of financial innovation in this case referred to the edges of regulation. How did state regulator react to this game of the tortoise and the hare? How can we explain the relatively successful regulation of this sector in two countries (Spain and France) and its failure in Germany and the Netherlands?

The fourth chapter investigates the dialogue between audited and auditors regarding off-balance sheet decisions and ask how the auditors’ voice in this realm could be strengthened in order to limit regulatory circumvention. Strengthening the negotiation power of the auditor through principles based accounting standards is identified as an important tool to contain regulatory arbitrage in the dialogue between banks and their auditors. The fifth chapter asks why we see the introduction of such accounting rules and their use for banking regulation in France and Spain, whereas they are either not introduced at all or not used for banking regulation in the two other cases. It is shown that the engagement of the banking regulator is a decisive intervening variable in the process. It is pointed out that the reconfiguration of national accounting standards setting networks amidst the transnational pressures emanating from an international standard setting body had a strong impact on the differential capability of banking regulators to influence this process. In the sixth chapter, the monitoring and enforcement of auditing decisions in the different countries are investigated, showing that principles based standards without strong regulatory monitoring and intervention was prone to failure. It is shown that the absence or

engagement of banking regulators in these processes made a difference as to how prudently banking conglomerates demarcated their balance sheets and represented the risks they were taking. The seventh chapter finally situates the national evolution of regulatory treatments in the (lagging) international response to regulatory arbitrage in the field of securitization. It makes the point that deficiencies in the regulation of the sector were known internationally almost a decade before new international regulation was enforced and shows that in the interim period concerns over national competitiveness often inhibited the stringent regulation of this global market on a national level.

The findings of the study reveal the necessary legal capacities and technical capabilities regulators need to hold to spot regulatory circumventions at the margins and at the overlap of regulations. They point to a holistic approach to regulation, which does not only include the application of rules to certain data material but also the control of the construction of that data material itself. It also brings to the fore the tensions between the national and the global level of regulation located at the edges between the two. In these interstices, we can find permitted/ approved regulatory arbitrage as national regulators choose to protect the competitiveness of their banks in a global market, rather than imposing a prudent view nationally.

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Dedications

This dissertation is dedicated to my family:

To Constanta Alina, whose incredible strength stabilized our family when everything else was moving. Thank you for giving us a home, I love you.

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Chapter 1: INTRODUCTION

1.1 Introduction

The financial crisis which started in the summer of 2007 in the United States of America quickly engulfed Western European banking systems, and with the bankruptcy of Lehmann Brothers in September 2008 reached a global dimension, causing a recession in all major developed countries in 2009. The fact that a problem in the subprime sector of the United States of America could lead to a systemic financial crisis first in the US and then around the globe surprised many economists and has led to much work seeking to explain it. The rising interlinkages in the financial system between banks and financial markets have been at the centre of this explanation (s. Shin 2010), pointing to the information asymmetries created through securitization (Stiglitz, 2010a: 22). The crucial role the shadow banking sector, a sector of largely unregulated financial institutions engaged in banking activity has played in this transmission has been clearly demonstrated (s. e.g. Gorton 2010, Acharya and Schnabl 2009, Poszar et al 2010, Adrian and Shin 2009, for a theoretical perspective s. Battiston et al 2012). To these analysts, the failure of securitization to spread financial risks as predicted by economic theory (Bhattacharya et al 1998, s. esp. p. 765f) and instead to act as a mechanism that concentrated risk in the banking system is key to understand the crisis (Acharya, Schnabl and Suarez 2009: 1, Greenlaw et al. 2008: 35, Gorton 2010). The return of impaired, ‘toxic’ assets on the balance sheet of banks from the shadow banking sector impacted them heavily, contributing to the \$2.6 trillion of losses concentrated in the banking sector (s. IMF 2009c: XII). The unexpected return of these assets increased uncertainty over the true risk exposure of these banks, sowing distrust and contributing to the freeze in the inter-banking market. The crisis

revealed the close interlinkage between the banking and the shadow banking system, and it is the impact on the banking sector which made this crisis systemic and global. In order to increase system stability, it has been concluded that regulation needs to be made more comprehensive and to include these shadow banks into the system of banking regulation (Financial Stability Board 2011b).

But this raises the question why these institutions in the shadow banking system were not put under banking regulation in the first place? The financial sector is one of the most heavily regulated sectors of the economy (due to its potential to produce large negative social externalities), which poses the puzzle how we can explain this regulatory permissiveness before the crisis. We need to understand the reasons for this gap in banking supervision in order to devise “robust” regulations which “can withstand attempts at circumvention” (Stiglitz 2009:12) for this sector in the future¹. Without an understanding of the failures of banking regulation, we are running the risk of instituting rules which close the current loopholes but are incapable of dealing with the underlying dynamics from which the shadow banking sector emerges.

This dissertation is seeking to make a contribution to this debate by inquiring into the interactions between regulators and the banking industry which allowed for the exponential growth of the shadow banking sector before the crisis. Were the dangers of these organizational innovations unknown to regulators? Were they all duped by “the smartest men in the room”, financial engineers which were simply hiding the risks? Which capabilities do states need to detect regulatory circumvention and limit it? The current financial crisis has not only raised the importance of these questions, it also has provided strategic research sites that allow constructing

¹ Stiglitz rightly emphasizes that “the ingenuity of man knows no bounds, and whatever system we design, there will be those who will figure out how to circumvent the regulations and the rules put in place to protect us” (Stiglitz 2010b: XXV, s. also Kane 1988, 2008). In response to this immutable fact, what is needed are regulations and regulatory systems which can adapt quickly to such circumvention and thereby become robust in achieving their goals.

empirically grounded answers to these questions. Not all banking regulators were equally permissive, and the shadow banking sector did not reach the same proportions in all developed countries. In the following I will explain the nature of the shadow banking system and its role more in depth in order to demonstrate the issues regulators had to grapple with. In a next step, I will trace the different impact of the financial crisis on European countries to the engagement of national banking conglomerates in the shadow banking system. This will allow me to establish the comparative argument for the four countries that I chose for my case study.

1.2 What is the bank-based shadow banking sector and which role did it play in the crisis

The organizational infrastructure of securitization requires the instalment of special purpose entities (in the following SPE). These were part of an array of new non-financial institutions, commonly called the “shadow banking system”, which together were engaged in credit intermediation. What before involved only one organization, the bank which was engaged in maturity, liquidity and credit transformation, in the shadow banking system was divided between different financial institutions. The shadow banking “essentially amounts to the vertical slicing” of traditional banks’ credit intermediation process and include loan origination, loan warehousing, abs issuance, abs warehousing, Abs cdo issuance, abs intermediation and wholesale funding”. This is done in a strict sequential order and with a specific type of shadow bank engaged with a specific funding technique (Poszar et al 2010:12). Such restructuring of the production of credit was largely aiming at circumventing banking regulation, by slicing the different functions of credit, liquidity and maturity transformation, such that no single entity involved would be characterized as a bank, whereas the network of linked organizations together

fulfilled the same function as a banking system.² These networks can be further divided into an internal shadow banking system which is directly linked to the banks³ and an external shadow bank system which is constituted by broker-dealers and other institutions which are not regulated by banking regulators.

The internal shadow banking system is motivated mostly by regulatory and tax arbitrage concerns, driven by Financial Holding Companies exploiting the legal frameworks to undertake their activities in the most beneficial space in terms of tax and regulatory requirements for credit transformation (ibid: 25⁴, s. Gorton 2010, Gorton and Souleles 2007, Ehrlich et al 2009, BCBS 2009b⁵, Hansmann and Matthei 1998). Financial Holding Companies were increasing their return on equity via reducing capital requirements for their lending activities (s. Poszar et al 2010: 26)⁶. Often, banks acted through special purpose entities, robot companies controlled by autopilot contracts, while being independent in legal form, thereby keeping the assets inside of these special purpose entities outside of the balance sheet of the Financial Holding Company.

² “The shadow credit intermediation process binds shadow banks into a network (s. exhibit 3), which forms the backbone of the shadow banking system and conducts an economic role that is analogous to the credit intermediation process performed by banks ... In essence the shadow banking system decomposes the simple process of deposit-funded, hold-to-maturity lending conducted by banks into a more complex, whole-sale funded, securitization based lending process that involves a range of shadow banks” (Poszar et al 2010: p.13)

³ This means that the activities of these shadow banks acted with indirect official enhancement of depository institutions, like lines of credit to special purpose entities. In this internal system, the goal was to transform risky long term loans into seemingly risk free short term money market instruments (s. Poszar et al 2010: p.14) and to earn the spread between the underlying loans and the interest to be paid to investors in the money market as fee income.

⁴ “Whereby each of these functions and activities were conducted from those on- or off-balance sheet corners of an FHC and in a manner that required the least amount of capital to be held against them” (Poszar et al 2010: 25)

⁵ In a survey by the Basel Committee in 2008, some large institutions reported having over 2000 affiliated SPE’s, “regulatory capital optimization” being a central motive (BCBS 2009b, p.35)

⁶ As we know now, the entire financial system before the crisis was based on the symbiosis between banks, broker-dealers, asset managers and shadow banks, which generated a fee-based high return on equity for Financial Holding Companies. This business model is highly dependent on liquid wholesale funding and global debt markets; if that is not given the business model of FHC’s breaks down.

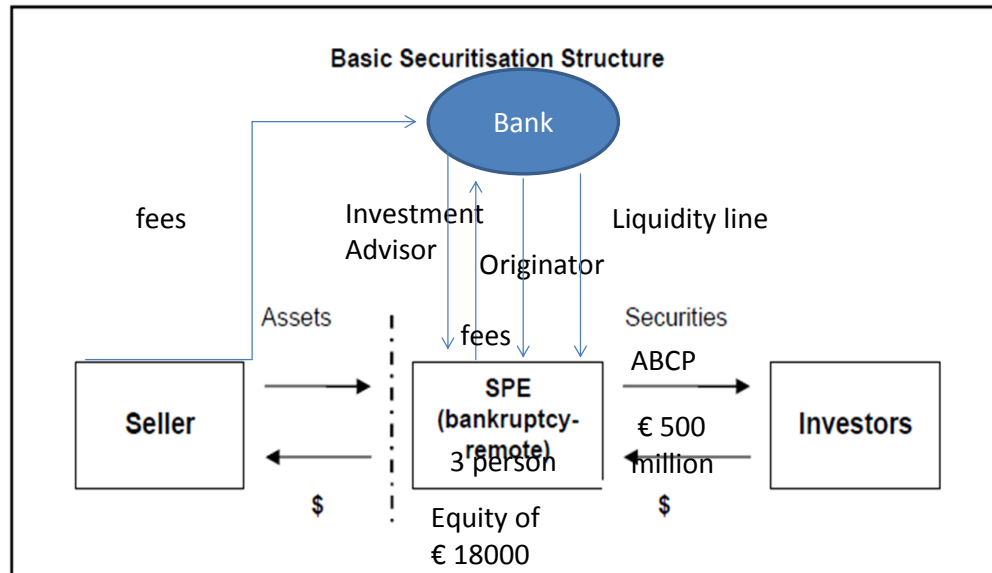


Figure 1: Role of banks in securitization

(Source Basel Committee 2009a, enlarged by some common features of support from banks for SPEs, based on a typical Dutch SPE, s. Brinkhuis and van Eldonk 2008: 216)

As can be seen above, banks as originators and sponsors of the SPE⁷ were central to their functioning. They gained fees from the companies which refinanced their credits in financial markets via the SPEs, they acted as investment advisors to the SPE, they often handled all the paper work for the SPE and they provided the SPE with a liquidity line in case there should be a problem with the refinancing in the money market. Given the minuscule amount of equity these entities held, such a liquidity support was desperately needed.⁸ The special purpose entity could not exist without its banking sponsor, especially in the money markets (Asset-Backed Commercial Papers markets), in which the average duration of a commercial paper was 40 days. The most evident relationship of regulatory circumvention of sponsoring banks for SPEs in the internal shadow banking system was for securities arbitrage conduits, which served the function

⁷ The originator is the corporation which sets up an SPE, the sponsor the one which supports its day to day operation. Over the course of the lifetime of an SPE, the sponsorship may change in case a financial holding company wants to divest itself from this business.

⁸ A typical Dutch special purpose entities, for example, is holding 18000 Euros (s. Brinkhuis and van Eldonk 2008: 216) given that such SPEs might issue Asset-Backed Commercial Paper of 500 million Euros or more in the money market. Such an SPE was effectively dealing with a leverage of 1 to 27777, it was in the language of the accounting rule FAS 46R not viable without subordinated financial support.

of off-balance sheet proprietary trading of banks. For these conduits, the seller to the SPE became the banks themselves or other banks selling long-term Asset Backed Securities to the SPE, which then were refinanced via short term Asset-Backed Commercial Papers, transferring the spread as fee income to the bank (s. graph 3 below). These structures were invented in 1988 by two Citibank bankers in conjunction with British and American lawyers as a mode of regulatory arbitrage, in order to comply with Basel 1 capital requirements, without having to shrink the actual asset size of the bank's assets (s. Ehrlich, Anandarajan and Chou 2009: 30). A good explanation of the business model of these off-balance sheet entities is given in Acharya and Schnabl (2009: 2):

“banks use off-balance sheet vehicles to purchase long-term and medium-term assets financed with short-term debt. However, contrary to other forms of securitization, such as mortgage-backed securities or collateralized debt obligations, banks effectively keep the credit risk associated with the conduit assets. Hence, as long as banks are solvent, conduits are risk-free for outside investors but can generate significant risks for banks. In exchange for bearing these risks, banks have access to low-cost funding via the asset-backed commercial paper market.”

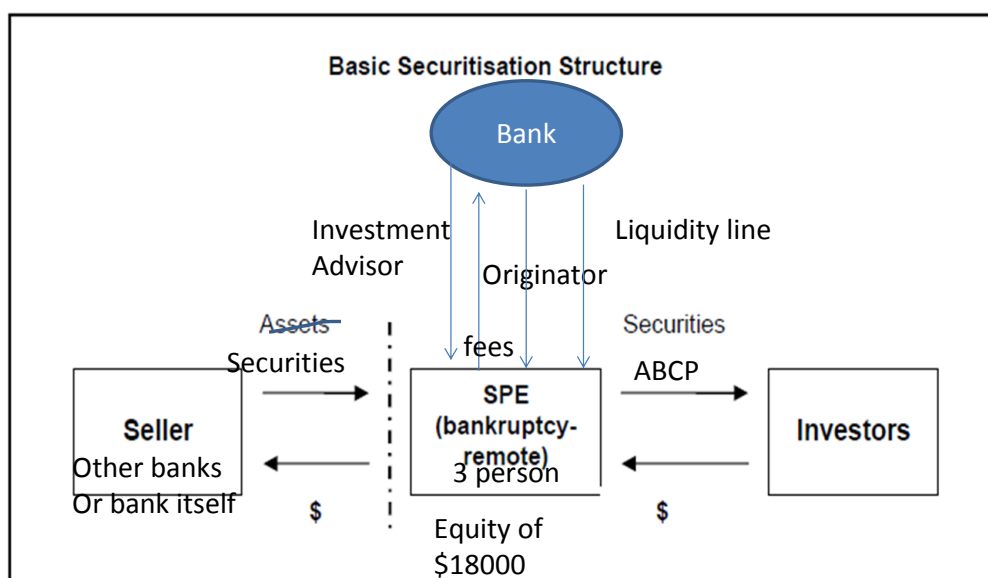


Figure 2: Securities Arbitrage Conduits

(Source Basel Committee 2009, enlarged by some common features of support from banks for SPEs, based on a typical Dutch SPE, s. Brinkhuis and van Eldonk 2008: 216)

It was at this point of the chain, where long term complex products were refinanced by short term papers. Given that these complex securities rapidly lost value in 2007, it is also at this point of the chain, where the “music” stopped in 2007, and where the liquidity freeze in the inter-banking market began. The dramatic impact of the crisis on the volume of Asset-Backed Commercial Papers outstanding in the US, a market in which, due to its liquidity many European banks were also active, can be seen in the following figure.

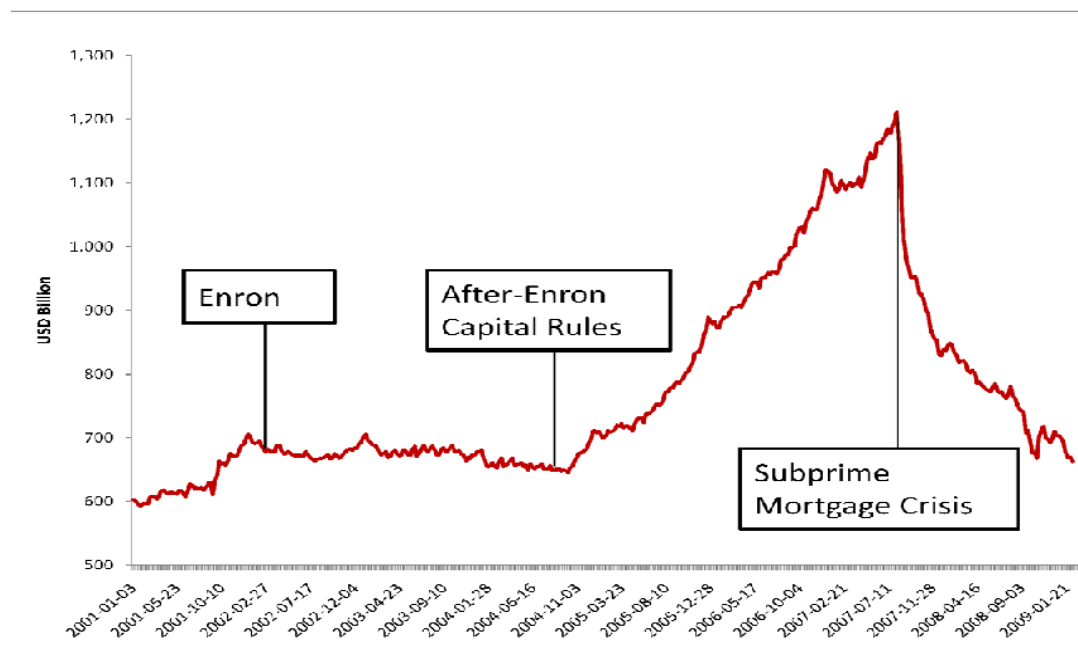


Figure 3: Volume of US Asset Backed Commercial Paper market
(Acharya/ Schnabl 2009: 40)

The market volume doubled in size from 2001 to 2007, but then collapsed, reversing its growth in the following 2 years. The decline from summer 2007 onwards is caused by the refusal of institutional investors to buy these papers any longer. Due to the institutional linkages of the banks which had sponsored the financial institutions involved in the issuance of these papers, banking conglomerates were forced to fulfill their promises of liquidity, which meant that they had to take the underlying assets back on their balance sheets.

In fact, the liquidity promises of the banks to the internal shadow banking system in the financial crisis turned into a credit enhancement, shielding financial investors of losses to such a degree that almost no triggers were drawn and almost no losses to investors emanated from this sector. Instead the strong shrinkage of the money market in asset backed commercial papers (between almost 100% for structured investment vehicles to 66% for securities arbitrage conduits and more than 50% for multiseller conduits, s. S&P 2010: 5f) led to a reappearance of the assets placed into these special purpose entities on the balance sheets of banks (s. Acharya and Schnabl 2009, 2010)

“Ultimately, it was the embedded rollover risks inherent in funding long term assets through short term securitization sold into money markets that triggered the run on the shadow banking system.” (Poszar et al 2010:50)

Like in the 19th century bank-runs, the fact that the assets of investors were not insured against the break-down of the system led to the break down of the system by a complete freeze in liquidity. The run on the shadow banking sector could only be stopped once public credit puts were put into place, as the private system which had provided such credit puts had come to create severe doubts over its ability to pay for them.

Of all the SPE's involved in the internal shadow banking system, the SPEs issuing Asset-Backed Commercial Paper are the only ones which undertake all three functions of banks (credit, liquidity and maturity transformation) at the same time (Poszar et al. 2010: p.18), which makes them the most bank-like. However, in almost no legislation, neither in Europe nor in the US, were these SPEs even deemed to be financial institutions, let alone credit institutions (s. chapter 6). They often remained off-balance sheet and the liquidity lines granted to them by banks were often excluded from regulatory capital charges. In those countries where they actually were

regulated, their growth before the crisis as well as their negative impact during the crisis was smaller as will be shown below.

1.3 The impact of the global financial crisis on European nations

The different impact of the financial crisis on the national financial systems of different countries has been linked to the extent the banking conglomerates of these countries were engaged in the shadow banking system, especially in the Asset-Backed Commercial Paper market (in the following ABCP-market, s. Jablecki and Machaj 2009: 302, Acharya and Schnabl 2009, Acharya, Schnabl and Suarez 2009, Diamond and Rajan 2009). In general, European countries compared with all other regions but the US have been disproportionately affected by the US subprime crisis. One reason for it was the strong engagement in the ABCP market.

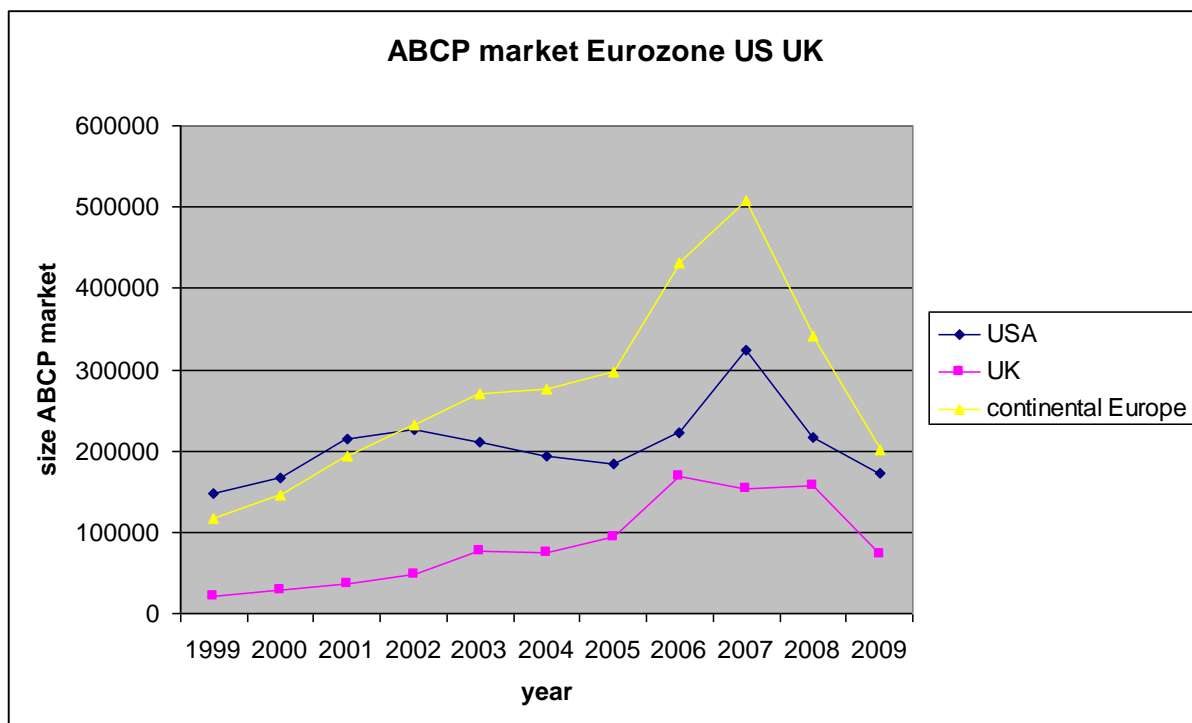


Figure 4: GLOBAL ABCP Outstanding by Region
(data Moodys)

What was even worse, European banks were especially active in the securities arbitrage segment of this market. 70 percent of the volume of securities arbitrage conduits were sponsored by EU-banks (Figure 5) (s. also Pozsar et al., 2010: 32f).

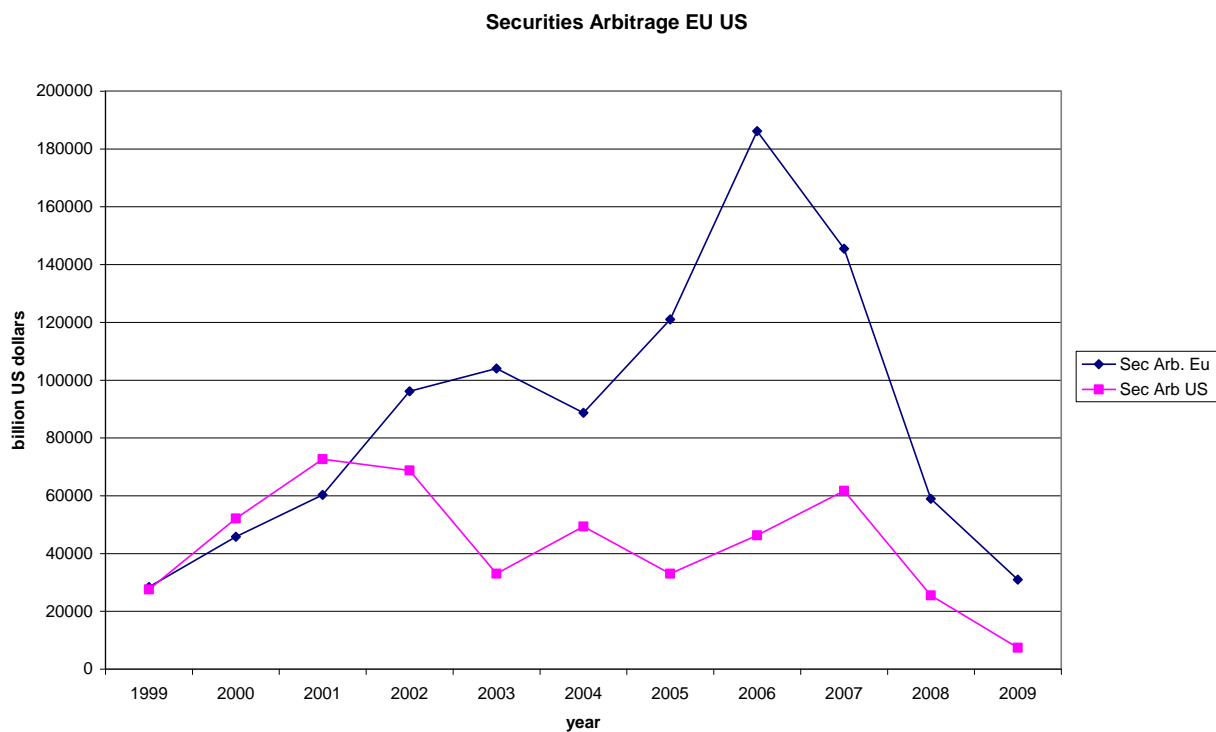


Figure 5: Securities Arbitrage Conduit Volume, US vs. Europe
(Data source Moodys)

This large exposure in the securities arbitrage market proved to be a huge source of loss-making. When the conduits could not refinance their assets in capital markets, the banks had to take these assets back on their balance sheets. Since the onset of the crisis in 2007 the ABCP market experienced a decline of about 50 percent in two years (S&P, 2010), securities arbitrage

conduits declined by between 67 and 74 percent, while multi-seller conduits only declined by 38 percent.⁹

In Europe itself, however, we find again much variance concerning the impact of the financial crisis as well as the engagement in the ABCP market. Analyzing the differences in the impact of the crisis around the globe, the committee on global financial systems, a subgroup of the Basle Committee comes to the conclusion: “it might be that the regulatory structure in respect to off-balance sheet vehicles is the determining feature for security of different banking sectors” (CGFS 2009: 6). In line with this observation, some countries have escaped the crisis rather unscathed, such as Spain¹⁰ or France, where ABCP conduits were negligible and regulated, while others such as Germany and the Netherlands have severely suffered due to the large scale engagement of their banks. Figure 6 below represents the engagement of banks according to their country of origin in the market segment of asset-backed commercial papers, which mostly has been off-balance sheet.

⁹This difference clarifies that while using the same construct, securities arbitrage conduits were disguised proprietary trading in complex securities, while multi-seller conduits served client needs.

¹⁰ This statement refers to the financial crisis that started in 2007, it does not refer to the subsequent Euro-zone crisis which has deeply engulfed Spain and threatens to engulf France.

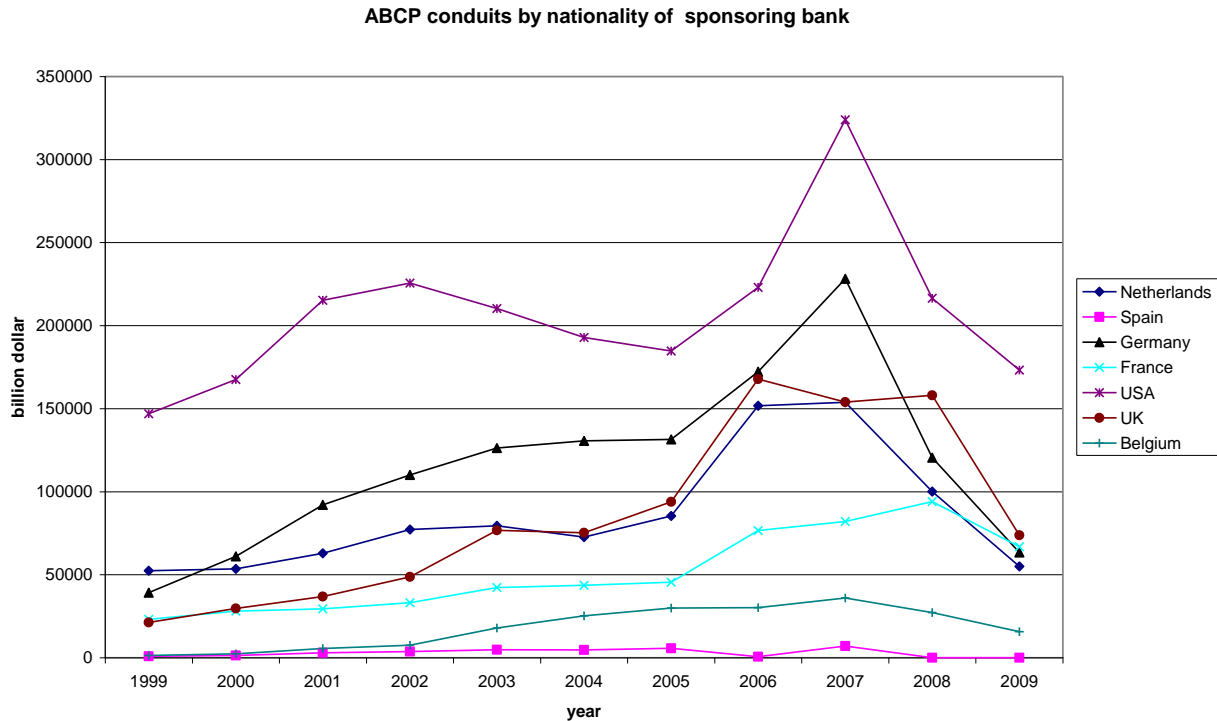


Figure 6: ABCP conduits by nationality of sponsoring bank (Data from Moodys Program Index)

Germany is the country which after the US, had the largest exposure to the ABCP market (228 billion dollar in June 2007), while the domestic market in Asset-Backed commercial paper in that year accounted for no more than 35 billion Dollar (TSI, 2008). France, on the other hand, had 82 billion dollar in Asset-Backed Commercial Paper in June 2007, of which 30 billion dollar can be accounted for by domestic asset-backed commercial paper. Spanish banks had such a negligible ABCP exposure that they barely appear on the graph (Banco Santander is the only bank which had such a conduit). Dutch banks sponsored programs with an astounding 150 billion Dollar volume, considering the size of the banking sector, most of them for credits outside of the Netherlands. What affected Dutch and German banks in particular during the crisis was the purpose of their engagement in the market.

In the beginning of the ABCP market, securitization techniques had been used by banks to facilitate the capital market access of their clients by offering to buy their credits and refinance

them in the capital markets. The entities facilitating these transactions are called multi-seller conduits and dominate the global market (Figure 7 below). From 1999 onwards, another type of conduit gained prominence, the securities arbitrage conduit, which grew in value from \$56 billion in 1999 to \$241 billion in 2006 (Moody's Program Index). These conduits no longer served clients or securitized loans the bank itself had originated. Instead it was a way for the banks to engage in securities arbitrage in capital markets, by buying long term assets and refinancing them with short term paper. Hybrids mix the activities of multiseller and securities arbitrage conduits, whereas single seller conduits are vehicles where the bank sells assets directly from its loan books to the conduits (conduits being the name for Special Purpose Entities in the ABCP-market). Here the main purpose is to generate further liquidity for the bank, but banks can also use these structures for regulatory arbitrage. The category hybrid conduits represents conduits where multi-seller and securities arbitrage business is combined. SIV (Structured Investment Vehicles) are a form of securities arbitrage conduits, however, they can also issue longer term notes and have more active portfolio management (s. Ehrlich et al 2009).

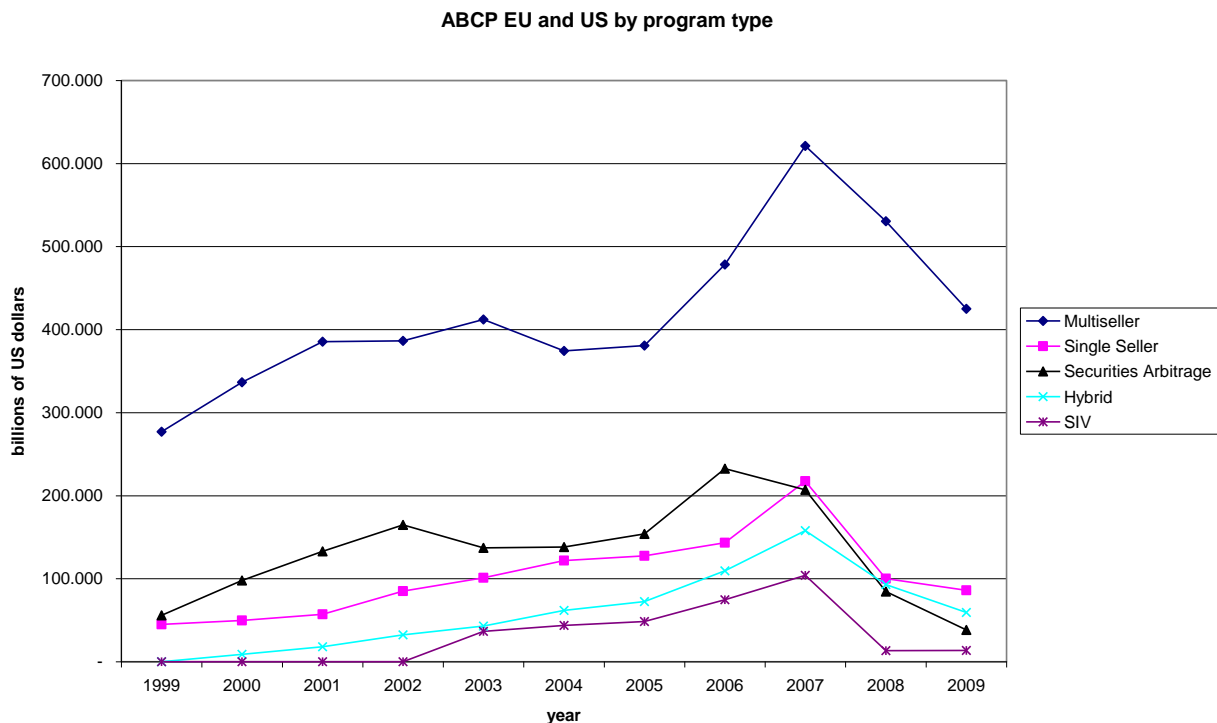


Figure 7: ABCP EU and US by program type
(Data from Moody's)

In 2007, German banks were sponsoring 7 Securities Arbitrage Conduits with a volume of \$60.213 bn, 9 hybrid conduits with a volume of \$52.312bn and 5 SIVs with a volume of 14.937 billion dollars. Dutch banks sponsored 8 securities arbitrage conduits with \$27.568 billion, 2 hybrids with a volume of \$7.568bn and 1 SIV with \$ 2.990bn. In Spain, there was only one hybrid conduit with a volume of \$284 million, and in France there were only 2 SIVs with a total volume of \$3.554bn. In line with these different exposures, the impact of the crisis in these four different countries has been very different. While the Dutch and German financial systems stand out as those continental systems whose large and complex banks have incurred the highest losses and precipitated many billions of credit lines and credit injections by the respective

governments¹¹, the French and Spanish banking systems incurred smaller losses and more limited government interventions (s.IMF 2009a).

Size of banking system/ size of losses from 07/2007-07/2010	Large	Small
Large losses	Germany (\$54bn)	Netherlands (\$ 14.8bn)
Small losses	France (\$23.3bn)	Spain (\$ 4.6bn)

Table 1.1: Size of banking system/ size of losses (source Onaran 2008, own calculation)

The different impact of the crisis on the Spanish, French, German and Dutch banking systems has been noted in both financial and academic circles (Tieman, 2009; Greive and Wuepper 2009, Griffith 2009, Salzman 2009, The Economist 2009, Hardie and Howarth, 2009; Aalbers et al., 2011a, 2011b). The French banking system incurred smaller losses and experienced fewer government interventions than Germany (IMF, 2009a). By the beginning of November 2010, Germany had injected capital and granted credit lines to the value of 417.5 billion Euros, the Netherlands had injected capital and granted credit lines worth Euro 52.15bn, while the French government had recapitalised banks and extended credit to the value of only 25.8 billion; in the case of Spain the equivalent figure was 10.7 billion Euro (R&S, 2011; Commission Bancaire, 2008; IMF 2009a, b). These different degrees of state intervention had become necessary while bank assets in 2008 in these countries were Euro 2.994739 trillion for the Netherlands, Euro 3.096 trillion for Spain, Euro 7,892.7 trillion for Germany and Euro 7,710.6 trillion for France (OECD 2012). Onaran (2008) estimates the losses of German banks in August 2008 at \$54.1 bn, while French banks had lost \$23.3 bn¹² and Dutch banks \$9.8 bn.

¹¹ While these are the countries with the biggest government intervention on the continent, Great Britain has been required to intervene the most in the European Union with £656.5bn (s. R&S 2009b, p. 9).

¹² The losses of Dexia as a Belgian-French bank (1.2bn) are not counted. In the first quarter of 2009, Natixis, the investment arm of Banques Populaire and Caisse d'Epargne took another 1.88bn Euro write-down on structured instruments (s. Mullen 2009).

Spanish commercial banks only wrote down \$4.6 billion dollars by end of 2008 (Sabuco 2009), and the savings banks were largely spared because they do not have much international business.¹³ Helaba (2009: 16) estimates German losses and write-downs at the end of 2008 at Euro 60bn and for French banks at Euro 30bn. At that point Dutch banks had written down around Euro 10bn¹⁴, excluding the ca. Euro 5bn lost by the largest Dutch bank, ABN Amro, which was bought in spring 2008 by a banking consortium led by the Royal Bank of Scotland¹⁵. In July 2009, the IMF enumerates total write-downs of German banks to constitute 9% of the total, while French banks only accounted for 3% (s. Hardie and Howarth 2009: 1017).¹⁶

1.4 The regulatory impact on the sponsoring of ABCP-conduits by banks

The differential exposure of European Banks of different national origins to ABCP conduits in general and Securities Arbitrage Conduits in particular can be largely traced to different regulatory capital charges for conduit activities. Regulatory capital charges are the capital banks have to hold in highly liquid assets in order to be able to deal with the potential risks of the banking business without going bankrupt. These regard especially unexpected credit

¹³ Since 2008, the economic crisis and the domestic financial crisis in Spain have worsened, with mutual feedback loops of high unemployment impacting a mortgage market based on too positive future projections. While these problems are grave, they represent a second order effect of the financial crisis that started in the US, as these problems were caused by the recession, not by the impact of the financial crisis on the banking sector.

¹⁴ ING Groep wrote down another Euro 3.7bn in the last quarter of 2008 (s. Financial Times Deutschland 2009). Accordingly, on April 08th 2009, Reuters lists the losses of ING alone at \$9.5bn. Rabobank had a write-down of \$2.4bn (s. <http://www.reuters.com/article/idUSN0852757920090408>). Together with the ABN Amro write down of 2.4bn in February 2008, this adds up to \$14.3bn. Additionally, smaller banks had write downs such as NIB capital, which announced losses of Euro 137 mio for the first half in 2007, due to subprime crises exposure.

¹⁵ According to the CEO of RBS, Stephen Hester, half of RBS' losses can be linked to ABN Amro. In 2008 these were between £7 and 8 bn (s. Campbell 2009).

¹⁶ A remarkable fact about the distribution of loss making banks is that in August 2008 2/3 of the write-downs in Germany were taken by public banks or banks with indirect public ownership. IKB Deutsche Industriebank which lost \$15.5 bn is counted among them as it was owned with 38% by the public Kreditanstalt fuer Wiederaufbau. The IMF consultation paper on Germany states: "As of end-September 2008, Germany accounted for about a quarter of European bank write downs. Of these, about two thirds have been in public or quasi-public sector banks." (IMF 2009, p. 12) 37% of the losses were incurred by non-profit maximizing banking entities in Germany and 42% of the losses in France were incurred by mutual banks and savings banks.

losses from assets which are deemed part of the banking group¹⁷. Banking conglomerates need to keep this capital in cash or other very liquid assets in order to deal with risk events quickly. Given these high liquidity needs, this capital generate little to no income. Therefore regulatory capital requirements are costly to banks in the sense that they cannot employ the money in a more profitable way (opportunity costs). Given the small margins that were earned in engaging in securities arbitrage conduits, banking regulators could discourage banks from operating in this market by applying capital charges to their activities, either by forcing banks to consolidate these SPEs on their balance sheet or by applying capital charges to the supporting liquidity lines the banks had pledged to their SPEs.

The figure 8 below represents the number of securities arbitrage conduits in these four countries over the period from 1999 to 2008. As can be seen, there is a high correlation between the number of these conduits and the size of losses.

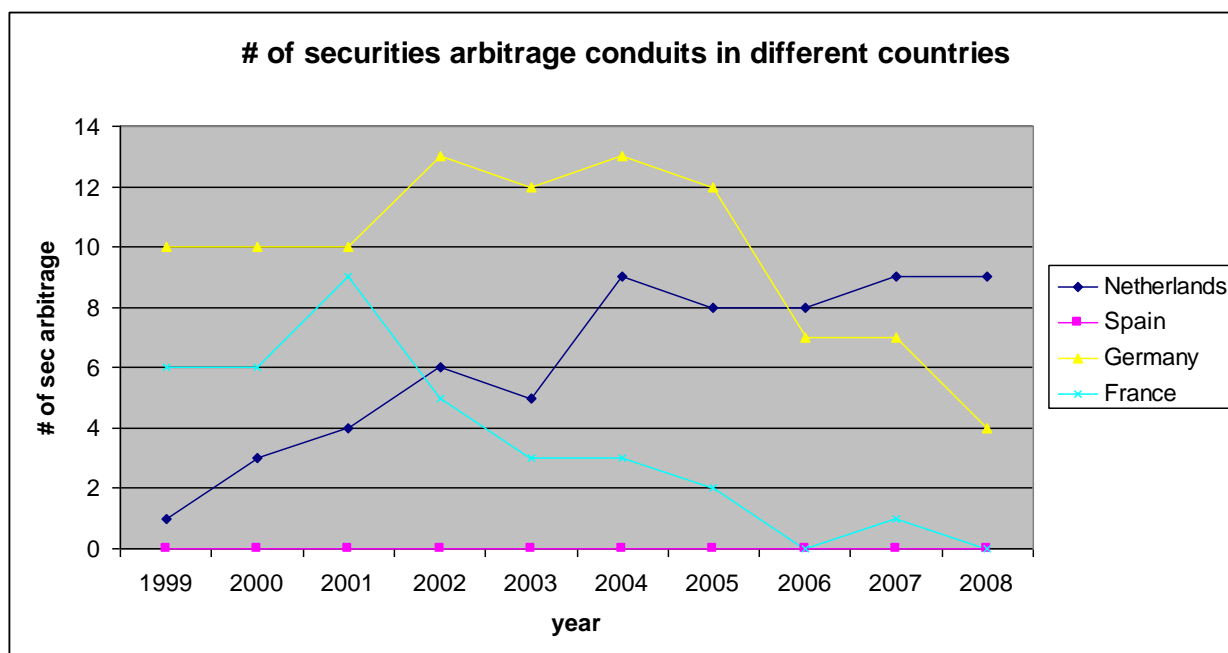


Figure 8 Securities arbitrage conduits

¹⁷ The amount of capital to be withheld is calculated according to the perceived risk of the assets.

A very interesting feature of this graph is the growth of this segment in France until 2001, and its subsequent reduction. As I will show in the following chapters, this development is by no means arbitrary but the direct reaction to regulatory action by the French banking regulator in the realm of accounting and banking regulation concerning capital charges for the SPE's of French banks.

Intervention in the realm of accounting rules was necessary due to the specific nature of core capital charges. If banks are deemed to control another entity (such as an ABCP-conduit), the assets of that entity appear on the balance sheet of the banking group and the banking group can then be forced to account for the "riskiness" of those assets by being asked to build up additional capital reserves. The calculation of required capital reserves in the Basel regime is applied to the assets of the banking group, which includes all entities under the direct control of the bank which are engaged in business related to banking. These core capital costs that may ensue if a bank has to consolidate an SPE on the balance sheet of the banking group can have a decisive impact on the decision of the bank to establish the SPE in the first place (Interview with senior manager in German bank, 12th of July 2011).

On the other hand, if placed off-balance sheet, securities arbitrage conduits impacted favourably on required capital reserves in three ways. First, the bank could reduce the regulatory capital reserves, which they needed to hold. Second, banking groups which engaged in SPEs kept most of the revenues generated by the SPEs by making them pay fees for services to the sponsoring bank. These services included the selection of assets to be bought by the SPE, the collection of revenue from the assets held by the SPE and the pay-out of interest to investors of the commercial papers. Thus the entire business activity of the SPE was outsourced to the bank. Third, and as a consequence of these two effects, the return on equity, for banks improved (in

some cases such as IKB Deutsche Industriebank AG, markedly) as a consequence of this off-balance sheet activity¹⁸. For these reasons, off-balance sheet securities arbitrage conduits were extremely attractive for banks, especially for those with poor returns on equity (Bannier and Haensel, 2006, Haensel and Krahnen, 2007). The margins for this form of “proprietary trading outside of the banks’ balance sheet” (interview German banker, 06/14/2011) are however, not very high (s. Acharya, Schnabl and Suarez 2009, Hellwig 2010). While exact margins are not known, they are estimated at between 10 and 30 basis points¹⁹ (Hellwig, 2010: 27), which creates the need to trade in large sums. An effect of this low profitability is that if banks are forced to hold regulatory capital in liquid, low-return assets to cover the unexpected losses of the assets placed into these conduits, these entities become unprofitable due to the high opportunity costs of regulatory capital (s. *ibid*: 26). The off-balance sheet status of SPEs and the assets placed into them were crucial to manipulate earnings and regulatory capital requirements. At the same time that banks were structuring their relationship to keep these SPEs and their assets legally off-balance sheet, they sought to maintain control over the assets they transferred to the SPE’s. This required an exercise in law-abiding regulatory circumvention in the field of accounting.

The extent to which banking regulators could interfere with these practices was limited by the degree of modernization of national accounting rules. Modernization here is used normatively as the ongoing adaptation of accounting rules to limit the misuse of accounting rules by firms to artificially improve the accounting information they provide to financial markets.²⁰ In my case this misuse involves the creation of SPEs by banks to legally transfer assets to them,

¹⁸ROE means return on equity, which is the earnings after tax over shareholder equity.

¹⁹ Which is a 0.1 to 0.3 percent margin.

²⁰As Veron et al. (2004:79) point out, those writing accounting rules are always in a step by step fight with fraud and perversion of existing rules with ingenious financial engineers, which test the limits. In this sense, modernization then can never be complete. With respect to special purpose entities, the international accounting standards were the first to introduce a new rule capable of limiting the misuse of special purpose entities.

which in economic substance remained assets of the bank. Regulatory capital charges are calculated using the accounting numbers provided by national accounting rules. If securitization special purpose entities are excluded from the consolidated financial statements of financial holding corporations, they thereby automatically are excluded from the prudential scope of consolidation, as the prudential scope is a subset of the financial scope of consolidation. Banks would structure their relationship with SPEs in such a way to make sure that these would fall outside of the financial scope of consolidation, so that they did not have to record them.

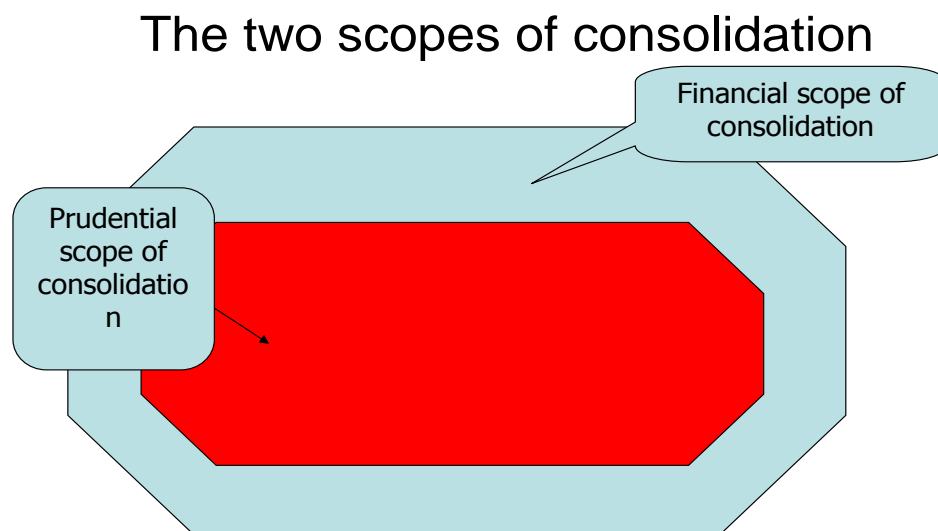


Figure 9 The Two Scopes of Consolidation

If the accounting rules were not explicitly changed with respect to SPEs, they were incapable of capturing the assets placed into SPEs as assets of the banking group. As a consequence, these assets would not be taken into account for the calculation of regulatory capital charges. Therefore no regulatory capital could be charged for the possibility of unexpected credit losses of these assets. But unexpected credit losses on those kinds of assets

which were placed into these SPEs were the main driver of the financial crisis. This explains the amplifying impact the assets in these SPEs had on the banking system, as the precautionary measure of regulatory capital charges were not applied to them before the crisis. The banking system was in essence not prepared to deal with unexpected credit losses of these assets, which in legal form had been transferred out of the banking system.²¹ The regulation of the off-balance sheet criteria in prudential accounting for special purpose entities and their linkages with the banking conglomerates were two instances in which the interaction of banking regulators with innovations from Anglo-Saxon countries made a difference to the impact of the financial crisis.²² If regulators forced their banks to account for the risks they took instead of allowing them to place it off-balance sheet, the extent of that activity remained small due to the lack of profitability of the activity. In how far banking regulators intervened in the activities of their banking conglomerates when these set up off-balance sheet vehicles is an important aspect of regulatory capacity of states investigated in my dissertation. I have chosen France, Germany, the Netherlands and Spain as cases for such an investigation as the differential presence of their banking conglomerates in the ABCP market suggests differences in the intervention of the banking regulators. This form of state action was partially shaped by the membership of my cases in the European Union, which was instituting an undivided financial market and a common minimum regulatory framework in its treaties and directives since 1985. These external constraints are the basis for the comparison, as state actors faced similar constraints and

²¹ The interesting paradox is that the accounting norms for off-balance sheet financing on the European Union level since 2005 were more stringent than in the US, but still securities arbitrage conduits were growing in the European Union. This paradox will be treated in chapter 5.

²² A further difference of French banks, as noted by Xiao (2009, p. 6), is that the regulatory capital adequacy of French banks was stronger than that of their European peers before the crisis. In 2006, the Tier I ratio of French banks was about 100 basis points above that of their peers. Related to this peculiarity is the extent of assets and liabilities French banks held at fair value (mark to market valuation), which increased the risk exposure and therefore the risk provisioning of banks. Spanish banks also had a comparatively higher regulatory capital reserve, due to the loan loss provisioning enforced by the Spanish banking regulator (s. Ramos-Tallada 2010).

challenges. They all had to apply the global banking regulatory framework Basel 1 from 1992 and the Basel 2 framework from 2007 or 2008²³ and were limited in their accounting rules by European Union Accounting Directives. It also implied that from 1990 onwards banking conglomerates of any European nation could set up their business in another, as long as they had a licence in one European Union member state. The opening of the domestic financial markets to all banking conglomerates of the European Union was increasing competitive pressure in the national markets, making domestic regulators worry over the future of their domestic banking industry. These common parameters are the basis of my comparison. In the following I will outline the different chapters to give the reader an overview of what is to come.

1.5 The structure of the dissertation

In the second chapter I show the similarities and differences of my four cases that are of relevance to the investigation. I thereby clarify the common parameters for the regulatory dynamics that I describe in chapters four to seven. I then discuss the profitability of the different banking systems as well as the recent structural changes they underwent in order to do justice to the different historical pathways from which these dynamics emerged. In chapter three I present the advantages and limitations of a small n-case study, as well as the analytic techniques I will use (process-tracing and comparative method). I then elaborate upon the data generation process for the 64 interviews upon which this study is based, their reliability and potential shortcomings. Chapter four analyzes the demarcation of banking conglomerates as a performative act, which constructs the banking conglomerates for observers and directly impacts the viability of banking conglomerates. Using interviews with banking regulators, auditing experts as well as banking

²³ A delay of one year was granted for those banking conglomerates implementing the more advanced version of the ratings based system

managers I document the heated negotiations over off-balance sheet accounting decisions between auditors and audited in the financial sector and its importance for financial products. Aided by regulatory advisors and corporate lawyers, banks are structuring their contractual relations with their special purpose entities to avoid the on-balance sheet status, while maintaining the maximum permitted risk exposure. This decision is crafted in an iterative dialogue with the auditor, appropriately called “stitching on the edge” by an interviewee. Banks thereby increase their actual risk exposure while keeping their recorded risk-exposure constant, leading over time to an ever widening divergence between recorded risks and actual risk exposure. Principles based standards, such as the International Accounting Standard SIC 12, which do not provide clear rules based criteria for the off-balance sheet decision, but instead delegate the decision making to the auditor are a way of constraining this practice of stitching on the edge by permitting the auditor to question dubious structures.

As I show in chapter five, the Spanish and French banking regulators played a central positive role in translating standard SIC 12, capable of capturing SPEs on the balance sheet, into domestic law between 1998 (when it was issued) and 2005²⁴ and used it to force their banking conglomerates to account for the risks they took. The German and Dutch banking regulators were passive or opposed to the introduction of these rules, and did not use them for capital requirements. In this chapter I relate these different stances to the reconfiguration of the national accounting frameworks in reaction to transnational pressures and its impact on the role of the banking regulator. The professionalization and transnationalization of accounting standard

²⁴ As will be shown in chapter six, once IFRS became the accounting framework in Europe for all banks listed on the stock market, most banking regulators in Europe decided to exempt the conduits consolidated under SIC 12 from core capital requirements, following a prudential filter proposed by Basle and the Committee of European Banking Supervisors in December 2004. However, this decision was not unanimous (as countries such as Spain or Portugal gold-plated IFRS rules to consolidate) and it did not represent the first encounter for European banking regulators with the question whether to apply core capital requirements to consolidated special purpose entities.

setting (International Accounting Standards) challenged the capacity of banking regulators to maintain a voice in the standard setting process, with the Dutch Central Bank losing its influence, while the French and Spanish maintained it. The German banking regulator, at a critical juncture of institution building for accounting standard setting (1998) was excluded in favour of convergence with the International Accounting Standards body. But the (changing) position of banking regulators is not the only decisive variable for explaining the differential evolution of this aspect of regulation of the asset-backed commercial paper market. Banking conglomerates and leasing corporations also mattered, as they used their veto-power and influence to shape the accounting rules for consolidation in their favour, most forcefully in France and Germany.

In the sixth chapter I link the different stances of the banking regulators towards SIC 12-like rules to their domestic position in the regulatory risk regime of accounting, with its three components information gathering and monitoring, standard-setting and the enforcement of these standards. I furthermore investigate the struggles over the interpretation of SIC 12 and SIC 12-like rules in the four different countries, once they were introduced. The inquiry shows the proneness of a principles based standard such as SIC 12 to fail if there is no active monitoring and enforcement of stringent interpretations of the standard. The comparison shows that banking regulators can make a big difference in this respect, if they push for a prudent demarcation of the conglomerates they regulate. Their capabilities and legal responsibilities in the field of accounting as well as their collaboration with the auditing networks are identified as the crucial differentiating variables.

In the seventh chapter, I test the validity of the insights gained from the two prior chapters for a larger sample of cases (all developed European Union members and the USA),

providing evidence of a strong correlation between the role of the banking regulator in accounting regulation and the stringency of the regulation of the ABCP business. In addition, I investigate the transnational dynamics involved in the national regulations of the global securitizations market. I contrast the fact that ABCP conduits were identified as instruments of rampant regulatory arbitrage by the Basel Committee in 1999 with the fact that in most of my cases, no serious measures were taken to delimit this regulatory circumvention until 2008, when Basel 2 came into force. I argue that this is an outcome of the under-inclusiveness of the Basel framework, which prescribed prudential regulation on the basis of consolidated financial statements, but did not provide a common framework for consolidated financial statements. This caused the “level playing field concerns” it sought to eliminate to reappear on the fringes of banking regulation, in the shadow banking sector. The lack of supervision in the shadow banking sector was driven as much by concerns over competitive inequities of domestic banking conglomerates compared with their competitors, as it was by what some analysts have called cognitive capture and/or cognitive closure of regulators with respect to securitization.

In the conclusions, the implications of the study for the debate on the regulatory state in the current phase of globalization are drawn out. The national regulation of global financial markets at the margins of global banking regulation is identified as providing the structural conditions for a “competition in laxity”. The impossibility to limit market access for shadow banking activities to foreign banks due to the rule of home country regulation dispossesses banking regulators from the possibility to force a higher common denominator for the regulation of these markets, putting competitiveness concerns centre stage. The lag in the global response to the regulatory arbitrage in the shadow banking sector is problematized and potential institutional remedies are proposed. It is furthermore assessed what the study implies for current streams in economic sociology. I

argue that the social studies of finance have provided us with great analytical instruments to understand the impact of evaluation on the behaviour of market actors. However, to make progress in our understandings of financial markets, we need to expand our analytical focus to include the political economy of these performative acts. The interplay between performative acts which constitute organizational actors and the attempts of these actors to shape the rules that govern these acts needs to be included in order to better capture financial market dynamics driven by the desire for appropriation. Studying these processes comparatively opens up the possibility for an understanding why performative acts, such as accounting for conglomerates take different forms in different countries and how they impact the distribution of risks and rewards in society.

Chapter 2: HISTORICAL CONTEXTUALIZATION OF THE FOUR CASES

Every researcher employing case studies needs to clearly answer 2 basic questions: “what is this a case off and b. from what historical pathway did this event emerge?” (George and Bennett, 2005: P.139). The first question requires us to define which class or subclass of events is investigated, as the cases in a given study must all be instances of only one phenomenon in order to lead to valid theory building (ibid: p.69). My case is a process of national accommodation of a US- innovation in different European countries in terms of the regulatory treatment to which it is made subject. The market is particularly sensitive to regulation, which need to be clearly set out by the regulator in order to provide regulatory certainty and permit the attainment of balance sheet relief, one of the most important factors motivating ABCP-financing. The ABCP market is a rather sophisticated segment of financial markets. It started in the US in the 1980s, but it only became a sizeable market in the mid-90s, with banks from other countries joining in the business. It is in the early 1990s when the regulation of this sector became an issue for the four cases investigated. This chapter is devoted to elaborate on the one hand why there are sufficient common background features that allow a comparison between the four different cases and on the other hand to describe the nationally different historical pathways of banking regulation, banking profitability and structural change of the banking sector up until the 2000s.

2.1 Case selection

Case selection for small n- studies cannot proceed as sampling for large n-studies as there are too few data points. Instead every case needs to be carefully selected, so that the cases have some common background features, but vary on the outcome variable (Rihoux and Lobe 2009:

231). The attempt of keeping some variables constant in order to be able to evaluate the interplay of others needs to be achieved by case study design (Smelser 1976: 241f). In my case study selection, I have chosen to select countries from a comparable historical and economic background, which were not the places of innovation of the particular techniques of securitization as I am interested in the adaptation of regulation to financial innovation which stem from other countries. In order to keep external regulatory constraints for each country constant (such as international regulatory agreements), I have chosen all four cases to be developed members of the EU. Three of the four (France, Netherlands and Germany) have prestigious financial centres, but not the predominant one (London), which puts them in a situation where they seek to attain that primary status or at least not loose further ground towards London. I have selected countries with different values on the impact of the financial crisis; which also have a sizeable difference in the size of a specific part of the shadow banking sector before the crisis, but which otherwise are rather comparable. I was therefore sampling on the outcome variable, a procedure which is criticized in the realm of OLS-statistics because “it can lead to a truncation on the dependent variable and thus biased estimates of causal effects” (s. Mahoney 2003: 351). However, this is not a problem for comparative historical research, which is using nominalist methods (such as Mill’s method of agreement and disagreement) to discern necessary and sufficient conditions (ibid., but s. King et al 1994 for a critique). There might be a problem of dependence between cases due to learning and diffusion. This is the reason for which I have paid particular attention to the recommendations of the Committee of European Banking Supervisors and the Basle Committee, as in both committees all four supervisors from my cases are present, and a certain diffusion effect of views is likely here (s. the sequential analysis in chapter 6).

By choosing two countries with extreme high values (Germany, Netherlands) and two with low values (France, Spain) in the immediate impact of the financial crisis and in the ABCP sector - I aim to establish necessary and sufficient conditions for successful prudential regulation at the national level. I have analyzed Spain as a control case, in which only secondary analysis is used to explain why the specific shadow banking sector is virtually non-existent in this country and if the hypotheses developed by primary sources for the other three cases hold for the case of Spain. The smallest possible subset in which all four cases can be subsumed for the period of 1995-2007 is that of Western European democratic members of the European Union with originally bank-based²⁵ financial systems which transition to a financial system in which capital markets play a greater role. They all have a code law tradition, which is important for the way their accounting system is linked to the state, as accounting regulation emerges as part of commercial law. The Netherlands is in this respect a slight exception. Even though it is a code law country, it is closer to the UK in terms of its accounting system, which is more common law oriented. France, Spain and Germany are often described as quite similarly driven by laws in their accounting framework (s. Radebaugh and Gray 2002), which stems from the common roots in the mutual exportation and adoption of accounting frameworks.²⁶

All four countries were faced with the same European Union directives, which increased the Merger and Acquisition pressure on their banking conglomerates and – notwithstanding their different institutional set ups – they faced the same pressures for minimum regulatory standards (s. Jabko 2006). European Union membership was an important parameter of regulatory action in financial markets, as the EU was instituting an undivided financial market and a common

²⁵ In opposition to capital market based systems, in which most financial market intermediation takes place in bond and equity markets.

²⁶ The French Plan Comptable Generale, introduced in 1947 was based on the Plan Goering, developed in 1941 in France, based on the work of the German economist Schmalenbach (s. Hoarau 2010). The German and Spanish law systems were influenced by the Code Napoleon.

minimum regulatory framework in banking regulation and accounting in its treaties since 1978. The EU treaties constituted an important common parameter for state action.

2.2 The EU framework limiting national discretion and catalyzing structural reforms

A very important impulse for financial liberalization, leading towards larger capital markets (part of a broader shift towards a more liberal Anglo-Saxon form of capitalism, s. Hoepner/Schaefer 2007, 2008:27) was enacted in the European Union since the early 1980's. While national initiatives in Germany, Great Britain (s. Busch 2009) and France (s. Coleman 2001) preceded the reform initiatives on the European Union level, the European Union has been a crucial actor in the process in accelerating sweeping financial market reform since 1985 (s. Jabko 2006: 56). The adoption of the "Directive for Free Capital Mobility" in the European Union in 1988 and its implementation into national law as well as the Second Banking Directive of 1989 (which came into force 1st of January 1993) strongly reduced the capacity of European nation states to control the investment activities of their large scale financial actors. National capital controls were abandoned, with the effect of adding to the free movement of labor and goods, already in place since the Treaty of Rome 1957, the (almost) free movement of capital. While the minimum standards for banking regulation²⁷ applied to the entire EU, the national regulators retained some policy initiatives regarding regulation up and above European minimum standards (s. Jabko 2006: 79). European officials as well as large scale banks expected a process of regulatory convergence to the minimum standards of the EU after the second banking directive was issued in 1989 (ibid). This expectation was fuelled by industry demands to generate a level playing field for all European banks. If some banks were allowed to hold more assets to capital than others, they would be able to generate more profits, given prudential risk

²⁷ Established by the European directives and enshrined into law in the Maastricht Treaty of 1992.

management. Such a competitive advantage might threaten the status of those banks under more restrictive regulatory requirements, which potentially could lead to the takeover of these banks by their rivals. But different regulatory structures and approaches to regulation remained in force (s. Moran 2002: 269). The lack of a cohesive European framework can be explained by “the options provided to EU members in the enforcement of common directives. These options led to a wide diversity of national transpositions related to local traditions, legislations and practices” (Larosieres et al. 2009: point 102). Common directives at the European level could be interpreted differently by national regulators. Financial regulation thus still resided with the home supervisors (Larosières et al 2009: point 103, 156, 160, 161). Vives (2001) identified the political struggle for control as an impediment to European regulatory cohesiveness: “At the heart of the problem is the tension between economic integration and the lack of willingness to relinquish national political control” (Vives 2001: 58). This fact applies to the implementation of the European Directives that transformed the two Basel Accords into European law, as well as to the European Directives on Accounting harmonization (as will be discussed in chapter five).

These remaining regulatory capacities at the nation state level and the ensuing differences allows national institutions in the European case to function as “filters of globalization” (Busch 2009: 238)²⁸, producing different responses to similar external pressures due to different domestic institutional configurations (s. also Luetz 2004). This specific constellation of similar directives which have to be implemented nationally allows the observation of the negotiation between national regulators, banking associations and other stake holders. In this reform of banking regulation we can observe the goal conflicts between generating rules for safety on the one hand,

²⁸ Busch’s analysis of the development of financial services policy communities, policy networks and regulation in the UK, USA, Switzerland and Germany points to the national continuities of policy styles, within which only the UK underwent substantial deviation. What his account unfortunately totally misses is a discussion of the changing interests of the banking industry towards a more fee-based banking model and the reaction of the financial regulators towards this changing risk-scenario.

and allowing the large universal banks to remain competitive on the other hand.²⁹ From a policy perspective, all states have an interest in prudent regulation due to the potential distributive impact of failure of large banking conglomerates. Large banking groups are more risk-prone as deposit insurance by national regulators and their too-big to fail status increase the moral hazard (s. Tarullo 2008: 26f). On the other hand, keeping large national banking groups competitive is important to national economies in order to maintain attractive financial markets³⁰ and expanding high-value added service sectors.

The literature emphasizes that the opening of European domestic markets to foreign competition put into law by the Single European Act of 1986 and enforced in 1990 aligned policy makers and national banking conglomerates in their attempt to secure viable positions for domestic banking conglomerates in the European market (cf. Walter and Story 1997). The pressure stemming from this market liberalization is founded in the take-over threats of domestic banking conglomerates by foreign banks.³¹ In the scenario of a European banking market, in which European, rather than national banking conglomerates dominate, smaller banking conglomerates in terms of share size become potential take-over targets for larger banking conglomerates. Reform efforts in all four countries since the second half of the 1980s were driven by these expected changes on the European level. The polities decided to make their banks more competitive in order to be able to compete on the European stage (s. Coleman 2001

²⁹ These negotiations need to be analyzed in conjunction with reform efforts on the European level, in which banking associations as well as national regulators were involved (s. Moran 2002, p. 270).

³⁰ See e.g. Coleman's account (2001), who explains France's deregulation drive in the 80's from such national government considerations.

³¹ This has become reality in Eastern European member countries, where the unfolding of the crisis demonstrates its negative consequences. Foreign banks market share in these countries has reached between 80 and 95% (s. Raviv 2008). When suffering capital shortages at home, western banking conglomerates withdrew money from their subsidiaries in Eastern Europe, choking off economic growth. This trend was partially halted by two international agreements, the Vienna initiative 1 and 2, which shows the impotence of Eastern European sovereigns to have any real influence when acting independently (s. Pistor 2011). In contrast, national policy makers can have more influence on domestic banks, as these banking conglomerates have to obey domestic rules and supervisory boards may host domestic politicians. Maintaining a large domestic banking sector is an important goal for state capacity.

for the French case, Luetz 2003, 2005 for Germany, Perez 1997 for Spain and Visser and Baerendregt 1997 for the Netherlands). All four states adopted financial reforms to react to increased market competition and the possibilities of hostile take-overs stemming from European financial integration, deregulating the banking sector to allow the stronger participation of banks in capital markets. But the process was driven either by banking conglomerates (Germany, Netherlands) or by the state (France, Spain), reflecting different capabilities and linkages of the state with the banking sector (s. Coleman 1997).

2.3 History of structural transformation and recent banking crises

Considering the historical pathways which conditioned the way the regulations of ABCP conduits would evolve, we need to take into account the capacity of banking conglomerates to shape the structural transformation of their sectors since the 1970s as actors in the governance of the banking sector which clarifies their power position in this period. Recent banking crises on the other hand might have generated different regulatory stances of the state towards financial innovation in general and off-balance sheet financing in particular. These two aspects will be debated in the following for the four countries.

2.3.1 Germany

For the German case, Luetz (2005: 304, 308) identifies the low market capitalization of German private banks, which threatened acquisitions by foreign companies as a rationale for the fervent pursuit of high return on equity by German private banks and thus a capital-markets based firm strategy. The large private commercial banks were an important actor endogenous to the financial system favouring changes in the financial sector, an initiative which was supported

by the government (especially the finance ministry, s. Luetz 2005:309)³². Private commercial banks had difficulties to generate a successful national banking strategy in a highly competitive market, and therefore shifted their orientation towards international financial markets (particularly investment banking) and on the other hand favoured domestically a structural reform of the financial system towards more capital market orientation (s. Luetz 2005, Deeg 2004). Their new firm strategy which relied more heavily on securities trading and underwriting made Deutsche Bank first, Dresdner Bank second and Commerzbank fourth among large European universal banks in terms of the capital devoted to investment banking and wholesale banking (s. Hackethal 2004:76). This strategic orientation led them to favour and actively pursue the development of the underdeveloped German securities market. A part of the public sector banks on the other hand, the Landesbanken, faced a profitability crisis and legitimization crisis since the European Union started to fight their status as state guaranteed banks, denouncing these guarantees as subsidies. The judicial fight ended in the withdrawal of the state guarantees in 2005, which threatened the business model of these banks. Before, they had largely focused on the wholesale market, borrowing money at cheap rates (due to the state guarantee) and loaning it to other (mostly public sector) banks. Their search of a new business model in this era, in conjunction with their predominant focus on the wholesale banking market led them to strongly engage in the ABCP sector since the 1990s.

Regarding the regulatory structure, in Germany, the Nazi-rule has been the historical moment shaping the set up of the state-banking system relationship in a lasting way. In that time, a corporatist policy network was created that included state agencies and peak organizations of the banking sector (s. Coleman 1996:81ff). In 1937, the Zentraler Kreditausschuss (central credit

³² Coleman (1996: 145) remarks that the overall changes were neither initiated nor driven by the state. Therefore changes tended to benefit the large banks and large investors, shorting the capital access for smaller banks.

committee) was formed, involving the peak organizations of the private banks, the publicly owned savings banks and the cooperative banks (s. Fischer and Pfeil 2004:298). In bringing together the peak organizations of the 3 banking groups, the German banking sector gained a forum in which these three groups could formulate common policy proposals due to political challenges they were facing together. In 1961, after the reunification of the 3 large commercial banks which had been split into 30 banks by the allies, the new “Kreditwesengesetz” (Law of the credit business) of the Federal Republic of Germany inscribes the corporatist policy style into law. State agencies do have to consult the associations before changes in regulation are made, most notably banking capital and liquidity regulations. In a continuation of this trend, when all financial regulators are united in 2002 in the BaFin, the financial sector receives 10 of 21 supervisory board seats in exchange for financing the agency. This close cooperation was not seen as problematic, as since the Second World War the banking system of Germany experienced no major turmoil up until 2007, with the exception of the failure of the Herstatt Bank in 1974, related to its engagement in international currency transactions.

2.3.2 France

Due to historical reasons of strong state presence in the commercial banking sector (Zysman 1983), the process of financial market liberalization in France was largely state-driven. In the securities exchange sector, the French finance ministry tolerated and/ or encouraged since 1981 the introduction of new financial instruments, which facilitated the access of investors to SME’s equity, allowed for more diverse options regarding the length of money market titles and had introduced instruments for hedging (futures and options). By 1987, Paris had thereby become an attractive financial center in Europe, with a money market deep enough to provide

cheap borrowing opportunities for the state (s. Coleman 1996:108). Loriaux states: “The clarity with which the French case reveals the impact of regime change on the domestic political economy is matched by the clarity with which it reveals centrality of the state in the process of reform” (1997:159, s. also Loriaux 2003, Schmidt 2002: 190, 2003).

The era of banking privatization which lasted from 1986 to 1991 undid the nationalization in 1945 of the 4 largest commercial banks and 36 additional commercial banks nationalized under the socialist government in 1982. In the second half of the 1980s Société Générale, BNP, Paribas and Suez were liberalized. While Banks were supposed to act like normal commercial firms, the state continued to shape markets, arranging mergers and acquisitions of its banks to increase the power of its commercial banks (the biggest one in 1999 of BNP and Paribas). This capacity was built on the fact that when privatizing the banks, senior management which were former state officials and products of the ENA system stayed, allowing for the state’s continuing influence via the senior management of the banks (s. Coleman 1996: 43). These close linkages however produced the bankruptcy of the Crédit Lyonnais in 1993, which with total losses exceeding \$30bn (with the tax payer absorbing \$20bn of that) became one of the largest financial scandals in French history. The French government urged the bank in 1989 to expand aggressively in order to become a global player and support the competitiveness of French banks and Paris (s. Coleman 2001). The problems of the bank stemmed from aggressive expansion of subsidiaries in foreign markets, which were not sufficiently supervised (the most dramatic case being the Dutch subsidiary) and on the other hand via semi-legal arms financing in the Middle East executed via off-shore vehicles to disguise these transactions (s. Jean-Pierre 1997). It is reasonable, given the size of the scandal, that the bankruptcy of Credit Lyonnais sensitized the French banking regulator Commission Bancaire to the dangers of

unsupervised subsidiaries and financial engineering.

Since the Vichy regime banking associations have been involved in the process of policy formulation and implementation, a fact that was formalized with the reform to the banking law in 1984 (s. Coleman 1996: 81). Since then, the newly formed peak association (l'Association française des établissements de crédit, AFEC) sits on the Comité de la réglementation bancaire responsible for banking regulation and the Comité des établissements de crédit, which decides on the applications for new entries into the sector. These centralized structures in both the French and the German banking sector lead Coleman (1996) to the conclusion that banking conglomerates in both countries were well instituted to translate their economic power into political power in the liberalization era. However, in France this capacity was intermingled with the state capacity to direct the action of banks. The Commission Bancaire, founded in 1984 constitutes a step away from the corporatist governance, as banking associations were excluded from its governance structure.

2.3.3 Spain

In Spain, structural deregulation since 1977 is more gradual than in France, seeking to preserve the high profitability of the banking sector, while the Central Bank (Banco de España) was seeking to implement reforms to the way the economy was financed (s. Perez 1997). This trend continues to characterize policy decisions of the central bank and the ministry of finance until the 1990s. In the 1980s, the ministry of finance was mostly staffed by officials from the central bank, some of which went on to become senior bank managers, thereby creating a tight policy network between the ministry of finance, the central bank and the private banks (s. Perez 1997: 145). With the entrance of Spain into the European Community in 1985 a second concern

is added, to “safeguard the national character of the banking sector” (s. Perez 1997: 152). Mergers and acquisitions in the banking sector were favoured by favourable tax treatments and were initiated by the central bank (ibid: 159f). The result was the creation of four large private banks from seven, seeking to generate size to protect from take-over (ibid: 162). In conjunction, state officials sought to vitalize capital markets in the second half of the 1980s to boost the profitability of Spanish banks.

Regarding the regulatory structure, the reforms in the decade after 1977 reduced the power of all state actors but the central bank to zero (s. Perez 1997: 126). The regulatory powers in the financial sector of the central bank were expanded in response to the two banking crises since the transition to democracy (s. Macuchan 2011). First the crises of industrial banking groups from 1978 to 1983, in which 51 of 102 operating banks had to be taken over. This crisis was related to fraud, or ‘managerial looting’ via subsidiaries and the industrial crisis during that time. As a reaction, in 1980 the Bank of Spain was given the combined power of prudential regulation, supervision and accounting standards with the “Ley de Organos Rectores del Banco de Espana” in 1980 (s. Ramos-Tallada 2010: 60) and since 1983 financial supervision has relied on consolidated supervision on the basis of consolidated financial statements (Ramos-Tallada 2010: 59). The second banking crisis occurred in the early 1990s and was coupled with a severe recession and a sharp downturn in consumer credit. It reached its pinnacle in 1993 with the nationalization of the largest Spanish bank, Banesto, due to the extreme overvaluation of assets of the bank (s. Perez 1997: 161, Macuchan 2011: 521). This overvaluation led to a more stringent control of accounting in the Spanish case, where loan loss provisioning is directed by the central banks rather than being left to the banks themselves as is the case in most European countries (s. Macuchan 2011: 509).

2.3.4 Netherlands

In the Netherlands, the banking community was a very active player in the structural reforms of the Dutch financial system. In the 80s they lobbied for mergers in order to be able to compete with the growing international competition and for structural deregulation in order to keep Amsterdam a competitive financial center. Baarendregt and Visser summarize this disposition in the Netherlands in this way: “with the rapidly approaching integrated European financial market, the Dutch financial world became convinced that Dutch banks, even the big ones, were too small to hold their own against international competition” (1997:175). In 1990 the stance of the Dutch monetary authorities regarding mergers became more lenient, now allowing insurers and banks to merge. The ensuing large merger wave produced 3 large and complex banking groups in the Netherlands, ABN AMRO, ING Groep and Rabobank, acting as universal banks and dominating the market. The increasing structural deregulation of financial market segments in the neighbouring countries forced a more liberal stance on the monetary authorities. In this respect, “the Netherlands, with its large sector of international firms, its important financial community and its concern for the future of Amsterdam as a financial center, could not remain on a slow lane” (Baarendregt and Visser 1997: 190).

The Dutch financial system did not experience a banking crisis during the inter-war years as many of its neighbours, or after the war until 2007 (s. van Zanden 1997:133f). Regarding the regulatory structure, we can notice decade long stability starting with the Bank Act of 1948 that placed all banks under the prudential supervision of the central bank, which itself was nationalized in that year. In the first two post-war decades the state, with its newly founded Herstel Bank and the Rijkspostspaarbank, a large depository institution under state control sought

to finance long-term credits. In the time from 1964 to 1992 the state would recede from its positions in the banking sector by privatizing banks, increasing competition for deposits and thereby lowering interest margins in the process (Baarendregt and Visser 1997: 171).

Summarizing these historical pathways, we can say that the Netherlands and Germany did not experience any major financial crisis since 1945 until 2007, whereas France and Spain did in the 1980s and 1990s, a fact which might have led to different regulatory stances and styles in these different countries. In addition, both in Spain and France state officials led the process of structural transformation and entered into careers in the banking sector, providing a linkage between the state and managers that was not existent in Germany or the Netherlands. What was common to all four countries in the 1980s and 1990s were structural deregulation and the increasing importance of capital markets for the financing of the economy and for the business models of banks.

These two measures had a self-reinforcing effect on the capital market orientation of banks, as new actors such as money market funds increased the competition for deposits, thereby negatively impacting the interest rate margins banks could realize (s. Hackethal 2004). The increasing importance of pension funds and other institutional investors on the other hand, led to a large supply of funds seeking for secure outlets in capital markets, which could be administered by banks for fee income. The question for the different countries then is how strong is the trend of declining interest margins and how well do the banking conglomerates deal with this decline in terms of generating new revenue via fee business.

The profitability as well as the structural changes in the sector is of importance to my study for two reasons. On the one hand, econometric research found, that banks with low profitability and low liquidity were more prone to engage in this segment of the market (s.

Haensel and Krahnen 2007, Bannier and Haensel 2006). Structural changes in the sector, on the other hand, disturb established market structures which guarantee the profitability of the business models of incumbents (s. Fligstein 2001). When structural changes occur, and the “conceptions of control” (ibid) harnessed and enforced by the incumbents in these markets are cast into doubt, a new struggle for market share and viable business models ensues, with the possible consequence of bankruptcies of several market actors. Empirical work on banks has shown that in such phases, in which the profitability and even survival of banks is endangered, these banks tend to adopt riskier strategies (s. Looi 1987), in its most extreme form they engage in “gambling for resurrection” (Freixas et al 2003: 5). Thus, if a country’s banking sector is in a phase of structural change, the likelihood for banks to engage in attempts of regulatory arbitrage. Lastly, to engage in regulatory arbitrage in the ABCP-market, banks and other financial market actors in my four cases had to be fairly sophisticated. In order to prove that there was a non-trivial probability of the generation of large scale ABCP-markets in these countries, I will need to show that this sophistication was indeed given (for the use of the distinction of trivial vs. non-trivial probability regarding an outcome as a case selection criterion, s. Ragin 2009: 531). In the following I will seek to clarify in how far my four cases differ with respect to the profitability of the banking system, the sophistication of financial market actors and structural change.

2.4 Comparison of the profitability of the four different banking systems

The general profitability of domestic banking systems in our four cases diverge largely before the financial crisis. Germany stands out as a country which saw a large decline in interest margins, but did not manage to generate fee income accordingly. An OECD economist summarizes it thus:

“Apparently, German banks were less able than banks in other countries to compensate for the decline in net interest income that occurred across countries as a result of deregulation and competition from non-bank sources. This problem is more pronounced for private banks” (Hüfner 2010: 14).

While interest margins steadily decline in all European countries, other countries than Germany have been far more successful in raising the non-interest revenue. French banks stand out as particularly advanced (s. Brunner et al. 2004: 14).

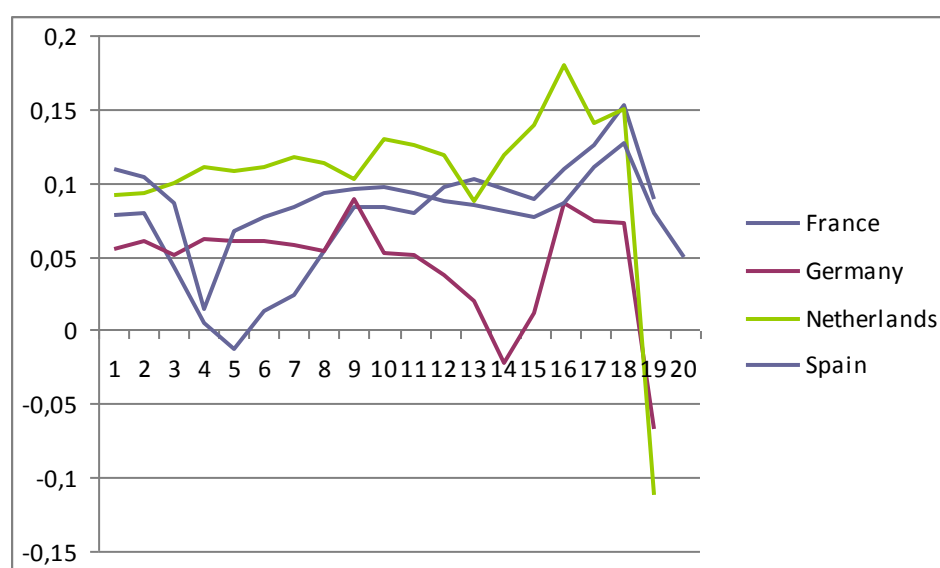


Figure 10: Profitability of the four different banking systems, measured by return on equity
(The x-axis is the time line, with one equal to 1990 and 20 equal to 2009.)

The average return on equity for the 19 year period (1990-2008) in the Netherlands is 10.64%, for Spain it is 8.67%, for France 7.3% and for Germany it is 4.53% (own calculation). As we can see, Germany’s banking system is the least and the Netherlands’ banking system is the most profitable. Spain and France are mid-field, Spain having almost twice the average return on equity as German banks. Profitability in France after 93/94 steadily improved (from 1% RoE in 1994 to 15.2% in 2006 (s. OECD 2012). Spain reaches a low of -1% in 1994, afterwards there is continuous improvement, reaching 15% return on equity in 2007. In the Netherlands,

profitability hovers around 10% return on equity from 1990 to 2002, then reaching an all time high in 2005 with 17%. Germany's profitability stays at around 6% until 1997, to reach 9% in 1998 then to continuously decline to -4% in 2003, recovering to an average 6% from 2005 to 2007. The 1997-2000 development is closely linked to the "Neuer Markt", the newly chartered German stock exchange for technological firms, which after its fantastic rise in value from 1997 to 2000 imposed heavy losses on banks in its following decline. In addition, the impact of the East Asian crisis was especially severe for German banks and the write downs on failed property investments made in the 90s in the early 2000s caused a deep crisis of profitability for the German banking system (s. Schmidt and Tyrell 2004). German banks have with a pre-tax RoA of 0.26% from 2000-2007 the lowest return in the OECD profitability data base, where the average for that period is 0.9% (OECD 2012). This low profitability relates to the structural features of the market for banking in Germany, which is divided into 3 pillars since the turn of 20th century, the savings banks, the credit unions and the private commercial banks (s. Deeg 1999). The former two pillars do not compete internally and span a very dense retail network in Germany, which caused problems for the large German private banks to penetrate the retail markets (s. e.g. Schmidt and Tyrell 2004). This high density and the predominance of relationship lending for external financing in Germany explain to a large extent comparatively low profitability. German banks are heavily engaged in the business of traditional intermediation, where they have to make high loan loss provisions which reduce their profits. The strong competition in this market also reduces the uptick that higher risk borrowers have to pay (Elsas and Krahnen 2004). Thus, while in Germany banks have a comparatively higher importance for the economy, their profits are comparatively lower (s. Brunner et al 2004, also IMF 2008:15).

This crisis was sustained by the fact that while net income in absolute terms increased, profitability in the margins decreased.

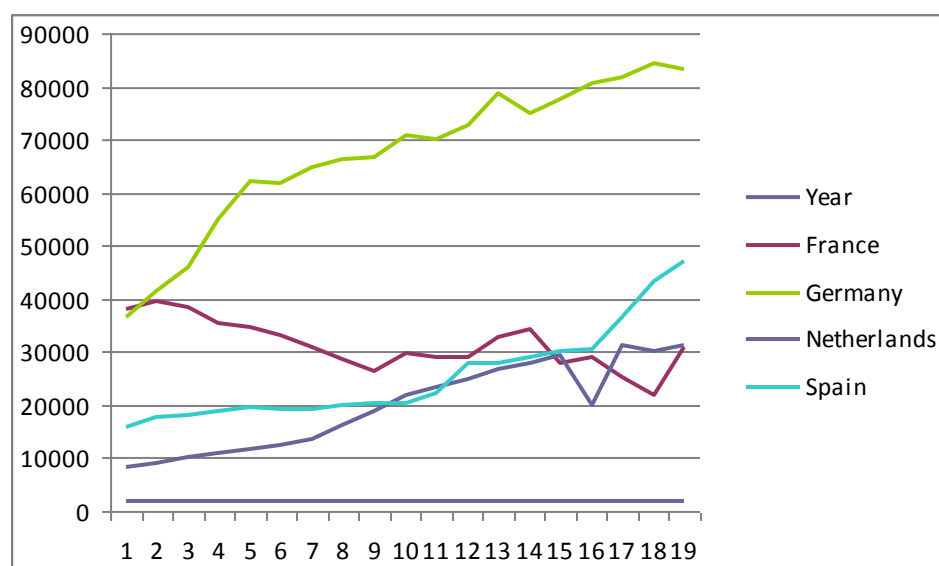


Figure 11: Net Interest Income in millions (1990-2008)

In the period from 1990 to 2008, net interest income doubles for the German banks and more than doubles for the Spanish banks, a clear sign of the continuing predominance of the loan segment as the main line of business for German and Spanish banks. In the meantime, however, the assets under management in these two banking systems increased by a factor of 3.35 in Germany and 7.34 in Spain (s. OECD 2012). In the Netherlands, there is a tripling of the net interest income until 2003, after which it stagnates, while assets under management have increased by a factor of 5.879. The French banking system is the system in which net interest income declines from 1990 onwards in absolute numbers by 33%, while assets under management have increased by a factor of 2.84. Looking at Net Interest Income as a percentage of total income we see the impact of these trends. The percentage is falling in three of the four cases, the fall is the most dramatic in the case of France, where it falls from 78% in 1990 to 26% in 2007. The case is almost similar for the Dutch banks, where it approximately halves from 71%

in 1990 to 36% in 2005, to increase dramatically during the financial crisis. In Spain, we see a much more moderate decline from 81 to 61%. Germany is the only country in which there is no clear downward trend, the percentage being 73% in 1990 and 74% in 2007.

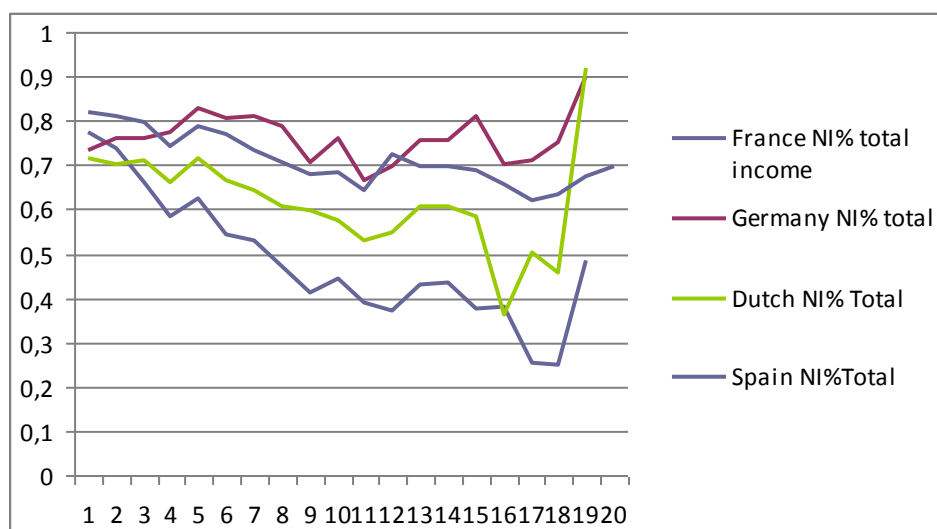


Figure 12: Net Interest Income as a percentage of total income

The weakness in generating net non-interest income has been ascribed to a weakness of the German banks to generate fee income (s. Huefner 2010: 14) as compared to its French and Dutch peers. This assessment seems to be borne out, when we compare the ratio of non-interest income to net interest income of banks in OECD countries, Germany has the lowest ratio (less than 1:2), followed by Spain³³. The ratio in the Netherlands is almost 1:1, whereas it is almost 2:1 in France.

³³ Net interest income refers to the money earned on loans minus the money paid for borrowed money. Net-non interest income refers to fee income, profits from financial operations and other income such as revaluations of assets. Net non-interest income and net interest income together constitute 100% of a bank's earning.

As % of total assets, average 2000-07

	Capital and Reserves	Income pre-tax	Net interest income	Non-interest income	Operating expenses
Austria	5.23	0.54	1.09	1.20	1.52
Belgium	3.60	0.53	0.89	0.76	1.02
Canada	5.50	1.03	1.92	1.92	2.54
Czech Republic	8.80	1.23	2.27	7.68	
Denmark	6.03	1.06	1.52	1.22	1.42
Finland	9.30	1.30	1.52	1.26	1.31
France	4.48	0.57	0.73	1.28	1.29
Germany	4.20	0.26	1.34	0.62	1.32
Ireland	5.15	0.81	1.22	0.71	0.97
Italy	7.01	0.91	2.15	1.05	1.87
Korea	4.79	0.76	2.79	0.44	1.40
Luxembourg	3.90	0.56	0.64	0.61	0.52
Netherlands	3.59	0.60	1.33	1.10	1.65
New Zealand	6.70	1.57	2.19	1.10	1.55
Norway	6.05	0.99	2.00	0.76	1.61
Poland	9.28	1.47	3.42	2.63	3.76
Slovak Republic	6.61	1.22	2.68	1.61	3.50
Spain	7.94	0.86	1.98	0.95	1.56
Sweden	5.75	1.05	1.11	1.40	1.55
Switzerland	5.47	0.71	1.06	1.57	1.55
United States	9.58	1.65	3.12	2.13	3.12
Unweighted average	6.14	0.94	1.76	1.52	1.75

Source: OECD, Bank Profitability Database.

Table 2.1: Performance Indicators of different OECD Banking Systems
(taken from Huefner 2010: 14)

However, the analysis of the OECD is actually mistaken in its identification of the root cause of the problem, as the fee income component is not the problem in the German case. A closer analysis of the data on bank profitability by the OECD reveals that German banks are comparable in absolute and relative terms to the French (actually leading them) and in relative terms to the Netherlands and Spain in terms of their fee based income. Fee based income is rising in the banking systems of all four countries.

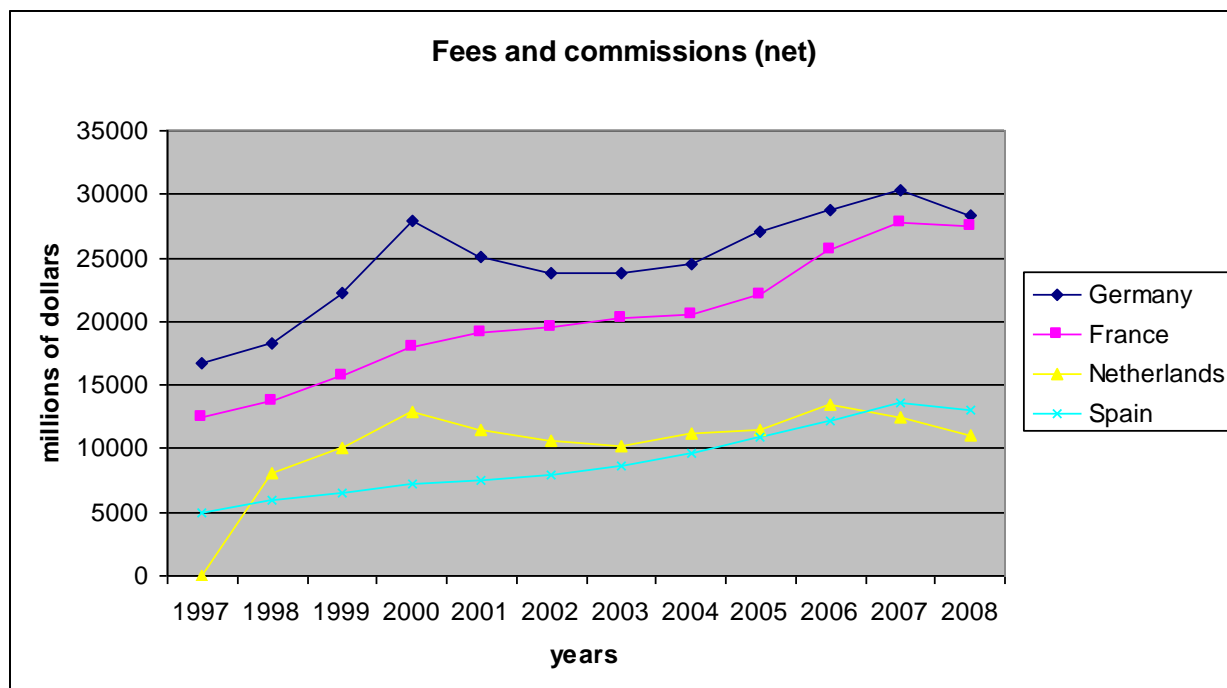


Figure 13 Fees and Commissions Net

In terms of their profits and losses from financial operations, the French are by far the most profitable, most likely due to the world class position of BNP Paribas and SocGen in FX-derivatives trading.

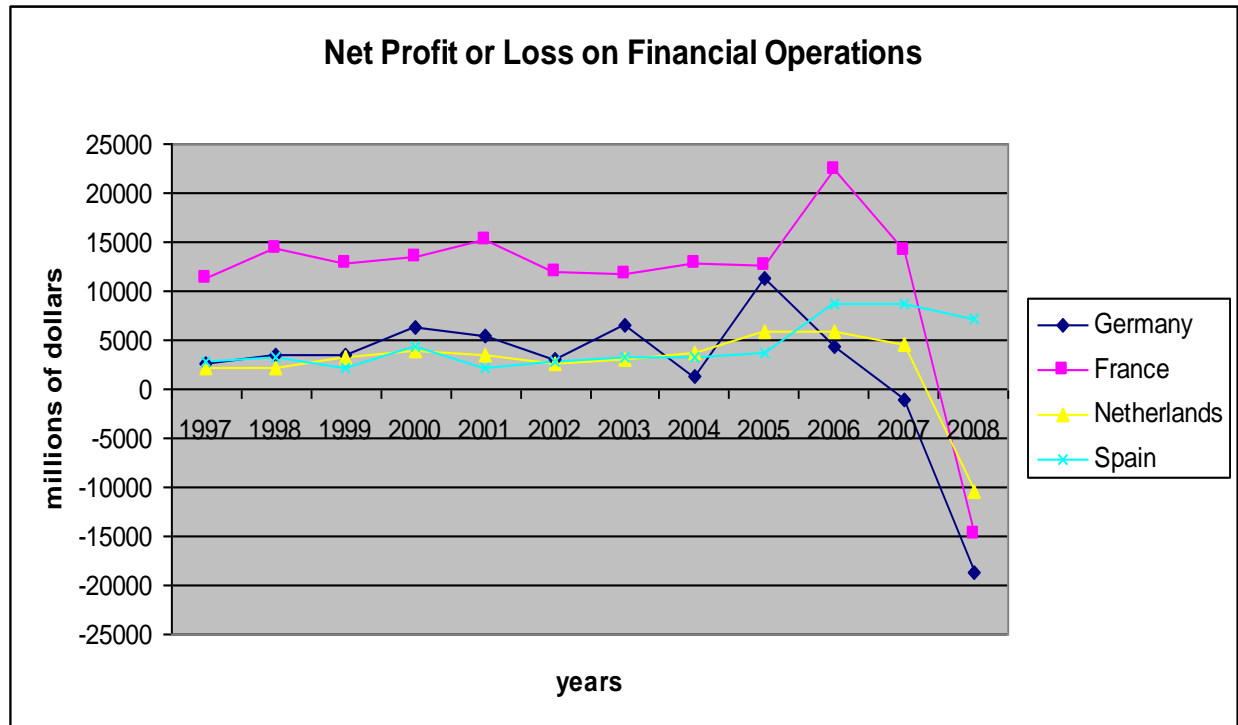


Figure 14 Net profit or loss on financial operations

These two graphs above show that France and Germany are comparable to each other, as are Spain and the Netherlands. In all four systems, the fee component and the profit from financial operations are increasing. The Spanish are catching up with the Dutch in terms of fee component in 2002 and have roughly the same results for profits from financial operations. This is not surprising, given that its two largest private banking conglomerates, Santander and BBVA are deemed world class.

The category which most markedly differentiates the German banking system from the other three is the category other non-net interest income.

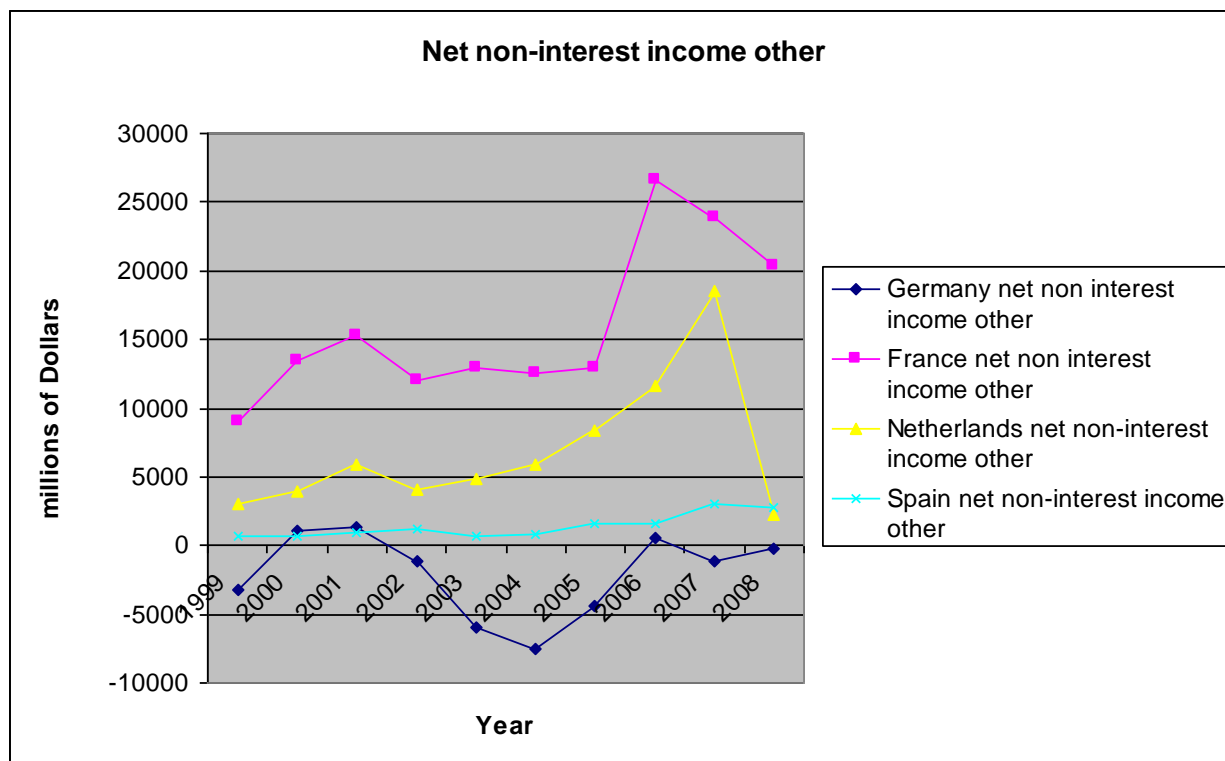


Figure 15 Other non interest based incomes for the French, German and Dutch banking system

In 2006, the difference in this single category between Germany and France amounts to 26 billion dollars, accounting for roughly 65 percent of the differences of the profitability of the German and French banking system in the category of net non-interest income. Value re-adjustments and loan loss provisioning are likely to have made the greatest contribution to this dismal performance in the German case (the OECD does not decompose the data further).³⁴

Summarizing these findings, we can see that all banking systems were moving from a bank-based system and were increasing their fee-based income, however with gradual differences. In Germany and Spain, the net interest income remained the predominant source of income. Regarding profitability, the Dutch and Spanish banking system have very high profitability. The

³⁴ The category other non-interest based income is a conglomeration of different categories, most importantly value re-adjustments in respect of loans and advances and provisions for contingent liabilities and for commitments, value re-adjustments in respect of participating interests, shares in affiliated undertakings and transferable securities held as financial fixed assets.

French system has rather average profitability in the EU, while the German system has a profitability crisis. Due to strong domestic competition and mistakes in investment, the German banking system was under great profitability pressure in the period from 1997-2008, which probably increased the inclination of German banks to engage in the ABCP market, due to its short-term profitability enhancing effects explained in chapter one. This especially applied to the Landesbanken, which besides the profitability crisis were suffering from structural changes imposed by the European commission.

2.5 France as the deviant case

As I am engaging in theory building for the capacity of states to limit regulatory arbitrage activities of their sophisticated banks, France is the deviant case and therefore particularly valuable for my comparative study. Due to its history and structural characteristics, it is a rather likely candidate for a large-scale ABCP market (for a definition of the concept of likely candidates among negative cases, s. Ragin 2009: 530). On the one hand the country underwent a strong structural deregulation program since the 1980's (s. Perraton 2007: 231f) and is now an economy within which financial services are playing an increasingly important role.³⁵ The leverage of the three largest banks (Credit Agricole, Societe Generale and BNP Paribas) in 2007 was between 30 and 40 and thus in the upper third of large and complex banking groups in Europe (Lapido/Nestor 2009:50). The banks had the highest percentage of assets and liabilities held at fair value (mark to market) in the trading book in 2007 in the world (as opposed to mere book valuation, which enters assets and liabilities at the expected value at maturity, s. CGFS 2009:11) which indicates increased hedging activities, engagement in OTC derivatives trading or

³⁵ France has the largest stock exchange on the continent, a large number of people employed in financial services and its largest banks stand on par with their European competitors. Tieman (2009) speaks of almost 1 million people working in financial services in France.

securitization or regulatory arbitrage (CFGs 2009). In line with these findings, the two largest banks of France, BNP and Société Générale are the leading banks globally in the Foreign Exchange derivatives market with a strong presence in London and New York. All these measures indicate that the large French banks were well integrated in the sophisticated financial markets which came to unravel in 2007. Furthermore the fee component (as opposed to the net interest component) of French banking activity is high, which indicates that French banking conglomerates are more active in financial markets than in traditional credit provision (Clift 2004). Furthermore, the regulatory services industry has a strong presence in France, providing the capabilities for regulatory arbitrage for the financial sector, as we can observe them in the ABCP-market. Also, France produced a regulatory framework for the set-up of special purpose entities already in 1988, almost a decade earlier than Germany or the Netherlands.

Despite the sophistication and early exposure of the large banking groups in France to the ABCP market, the size of that market remained relatively small and its impact on the balance sheets of banks during the crisis rather negligible. Why was this the case?

French banks were not less ingenious or deviant than their European counterparts proven by the fact that French banks engaged in negative basis trade, an activity which is functionally equivalent to the business model of a securities arbitrage conduit. The banks bought highly rated securities, such as CDOs and insured them against default through monoline insurers (s. S&P 2008: 4). This allowed them to reduce the risk weighting of these securities for the calculation of core capital requirements to zero. The yield of these securities was slightly higher than what had to be paid for the default insurance, thereby yielding a small profit to the bank (interview one of the big three rating agencies, Paris, 04/29/2011). The difference to securities arbitrage conduits was twofold. Instead of moving the assets off-balance sheet, their risk weighting was reduced to

zero. The second, more consequential difference was the impact these securities had on the French banks during the financial crisis, as banks had to acknowledge losses on their securities portfolio at a much slower pace than those sponsoring ABCP conduits.³⁶ Given these signs of ingenuity and regulatory arbitrage makes the difference in size and composition of the ABCP-market in France, in comparison to Germany and the Netherlands an interesting research site to inquire if state action was responsible for these different developments.

³⁶ When the financial crisis hit, these securities lost value but the banks were covered against default by the monoline insurers. However, as these monoline insurers were slowly downgraded themselves, with some of them eventually facing bankruptcy, so were the default insurance they had sold. With every downgrade of this insurance, French banks had to acknowledge losses on their securities portfolio. However, these downgrades occurred over a period of 3 years, giving the banks time to cope with the losses (interview one of the big three rating agencies, Paris, 04/29/2011).

Chapter 3: STRENGTHS AND LIMITATIONS OF SMALL-N CASE STUDIES

In this chapter I am reflecting on the strengths and limitations of small-n case studies and the methods of causal inference they permit. The specific subject (the development of the regulation of a specific sector) and its limited occurrence in the world, coupled with the necessity to study and master legal documents in the different languages limited the number of cases as well as the number of data points for each case. For this reason, a small-n case study seemed appropriate.

3.1 Why a small n case study

While this study is seeking to provide an explanation for the differential growth of the ABCP markets in Europe before 2007 and their specific national character, it seeks to extend beyond the idiographic goal of explaining the impact of this single dynamic and to distil regulatory styles and capabilities amenable to prudent financial market regulation of financial innovations. In this respect, it seeks generalizability and can be seen as a nomothetic inquiry that seeks to explain distribution of events (the different accommodation of a financial innovation based on regulatory circumvention in different jurisdictions) by evoking sufficient vs. insufficient regulatory capabilities and different regulatory styles. While large-n based statistical analysis might recommend itself for such a nomothetic goal, there are several problems with such an approach. Given the current state of the literature, which has not yet formulated causal mechanisms supported by strong evidence, undertaking a large n study in this moment of investigation would have had to be a rather exploratory exercise with the problem of having

scarce theoretical models to test for.³⁷ Even if these exploratory exercises would have produced statistically significant results, moving from statistical correlation to causal statements would have been difficult, given that statistical findings lack the detailed observation needed to specify mechanisms which are supposed to link independent and dependent variables. In particular they most often lack sequential data which link the interaction of different domains together to explain certain outcomes (law-making, reform efforts and/or regulatory efforts for example). Process tracing, based on interview accounts and official data can make sure that the sequence of events is properly traced and the reasons why the sequence of events unfolded as it did are properly appreciated. Process tracing allows the identification of causal mechanisms that link supposed causal factors with the outcome (s. Mahoney and Terrie 2009: 418). Such attention to sequence allows researchers to produce middle-range typological theories, “which identify recurring conjunctions of mechanisms and provide hypotheses on the pathways through which they produce results” (George and Bennett 2005: 8).

The empirical work that was available when this study was started were studies which were linking empirically the growth of a specific component of the shadow banking sector, the ABCP market, and the immediate impact of the financial crisis (s. Acharya and Schnabl 2009, 2010). Especially the hybrid and securities arbitrage segment of this industry were singled out as dangerous for the banking systems. These segments were based on acts of regulatory arbitrage which could be hindered/ stopped by regulatory state action. This work suggested that in order to find out more about the capacity of nation states to deal with globalizing financial innovations and to understand better the reasons for the differential immediate impact of the financial crisis, an analysis of the evolution of the regulation of the ABCP segment was adequate. Instead of

³⁷ In this early phase of academic research, within case study research often reveals that the understanding of independent and dependent variables is often inadequate and that therefore theories do not properly explain it (s. George and Bennett 2005: 21).

seeking to explain the differential impact of the crisis in its entirety, I seek to explain a smaller subset of events, focusing on the configurations of causes which led to the differential growth of this one sector. In particular I am asking how the more prudential point of view on this regulation prevailed in Spain and to some degree in France, where it failed in the Netherlands and Germany. In order to answer this question, I focus on the structure of the regulatory network, the organization of the communication flow in it and the instruments at hand for the different actors available for influencing the regulatory output.

3.2 Data and methods of causal inference

Cross case comparison and within case analysis based upon small-n case studies cannot be used for causal inference in the statistical sense of modern techniques (such as the set-up of “natural experiments”, in which treatment and counterfactual groups can be compared). It is nevertheless better able to deal with equifinality and conceptual heterogeneity than large-n statistical analysis. Equifinality describes the occurrence of the same outcome, which however is caused by different causal pathways (s. Goertz and Mahoney 2009: p. 314f)³⁸, and the problem of conceptual heterogeneity refers to the variance of different facts subsumed under one variable, a problem which is especially acute in financial regulation.³⁹ In seeking to formulate an explanation for each case, we employ causal imputation, rather than causal inference to comparative associations between independent, intervening and dependent variables that we discover in cross-case comparison (s. George and Bennett 2005:91, Smelser 1976: 34). In

³⁸ These different causal pathways can hardly be detected through statistical analysis, which builds its explanatory power on aggregation, rather than on distinguishing different cases.

³⁹ Consider the example of the collaboration of different agencies in financial regulation. While a simple dichotomy of “one agency vs. distributed between different agencies” might seem meaningful, huge differences can reside in the same category, e.g. between the case of the German financial supervisor (BaFin), where everything is officially subsumed under one heading, but the actual integration of the different agencies since 2002 is proceeding very slowly, versus the Financial Services Authority in the UK, which can be seen as a really integrated supervisor.

assessing causation with a small N, we are not looking for typical effects for a large population, instead what we are looking for is “whether a given variable *did exert* a causal effect on an outcome in a particular case?” (s. Mahoney and Terrie 2009: 417). As the authors clarify, this makes a distinct understanding of causation necessary, which focuses on the question if a certain variable is part or not of the subset of variables which has a causal influence on an outcome. As they state it, comparative historical sociologists ask: “did it exert an effect (alone or in conjunction with other variables) on the specific outcomes of interest in the particular set of cases that comprise the population?” (ibid). This change in question can be justified by the fact that if certain variables act as causes on an outcome only in combination with other variables, their correlation with the outcome might be small or statistically insignificant (s. Smelser 1976: 210). Even worse, the same variable with the same values might have had a different impact on a dependent variable, depending on its interaction with other variables in the different social units (ibid: 218f). The theory accompanying case study research emphasizes configurational causation, not linear causation. Factors in these models do not add up, instead it focuses on cases where only the existence of necessary and sufficient conditions at the same moment can bring about events. This analysis pays attention to timing and sequences of events and the specific configuration of actors in which these occur (s. Fiss 2009: 425, Harvey 2009), inquiring into the causes of effects (comparative-historical approach) rather than the effects of causes (statistical approach) (s. Mahoney and Larkin Terrie 2009: 419). It emphasizes that for causal mechanisms the temporal unfolding of events itself matters, just as in some chemical reactions where the presence of different substances does not guarantee a certain chemical reaction which itself is conditioned on a particular temporal process (s. Amenta 2009: 352f, Goertz and Mahoney 2009: 315).

The final account of necessary and sufficient conditions for certain developments (causal mechanisms) produced by process-tracing and cross-country comparison will provide plausible accounts, but is very open to refutation by future studies. While this is the case for all valid scientific theories, case study researchers need to carefully specify the scope conditions under which they assume their causal mechanisms to hold, in order to avoid fruitless refutation of their theories based on incomparable cases. In order to determine the scope conditions of the theory developed, it is important to specify those variables which are assumed as constant (act as parameters), as the theory can only speak about the causal influences of those variables it conceptualizes as varying (ibid: 241f). Comparative researcher are in this respect caught in the dilemma “between complex and realistic models of a historical process and simplified and comparatively verifiable causal relations, the causal significance of which, however, may differ among the societies in which they obtain” (Smelser 1976: 36).

The way that our imputations can gain greater credibility is by combining within and cross case comparison in a fruitful way. On the one hand, findings from within-case analysis can motivate and facilitate cross-case comparisons. On the other hand, we can engage in “pattern matching” (Mahoney 2003: 361ff). Pattern-matching is a technique operating between within and cross case comparison. Associations across cases imply certain logics and the researcher is checking if there is within case evidence which confirms these logics, i.e. if the variables which seem to have a causal effect in the cross-case analysis can be found to exert such an influence in the within-case analysis⁴⁰. This analysis, using process-tracing, helps to determine causal pathways and distinguish them from spurious correlation generated by cross-case comparison (s.

⁴⁰ An example of my own study shall clarify this point. If I find that the prudential regulators’ engagement in the regulatory network determining accounting standards is a causal factor in explaining the accounting and prudential treatment of special purpose entities, I need to find evidence for that in my within-case evidence. So the researcher is using the patterns he can observe and asks what needs to hold within my cases to confirm my cross-case comparison.

Mahoney 2003: 361ff). Seeking to link a supposed causal factor with an outcome, the absence of a link will then cast doubt on the causal role this factor is supposed to play. In this sense, if one has rival explanations it can help to decide which rival explanations actually holds. But process-tracing has more advantages, as it provides the data by which one can seek to isolate the determining actors and constellations which explain the outcome of certain processes, i.e. it can also be used inductively. Applying this technique, I am working inductively and deductively at the same time; seeking to test theories of state capacities, while at the same time observing sequences of events in order to generate new propositions and hypotheses. My work here can be summarized by the description of the method by George and Bennett

“in process tracing, the researcher examines histories, archival documents, interview transcripts, and other sources to see whether the causal process a theory hypothesizes or implies in a case is in fact evident in the sequence and values of intervening variables in that case. ...Process-tracing can perform a heuristic function as well, generating new variables or hypotheses on the basis of sequences or events observed.” (George and Bennet 2005: 6f)

The use of official documents, stating the preferences of different actors, allows me to compare initial preferences and final output, thereby establishing whose interests prevailed in the process (a procedure called congruence analysis, s. Hall 2007). The interviews are used to verify these preferences as revealed in the documents, as well as the causal pathways by which these preferences were realized. The triangulation of documentary analysis and interviews allows me to trace the driving forces in the dialogue between the auditors, the banks, the standard setters and the state agencies over the regulation of ABCP conduits over time. Process tracing, by identifying different turning points in the chain of events, can also give hints on necessary and sufficient conditions which need to be given for a certain faction to gain the upper hand in the regulatory dialogue. These sequential findings themselves can lead to further cross-case comparison in order to investigate hypothesis of necessary and sufficient conditions. However,

as Mahoney and Terrie remind us, it is much easier to eliminate conditions as not necessary or sufficient with the help of the triangulation of process-tracing and cross-case comparison, than it is to validate them as necessary or sufficient (s. Mahoney and Terrie 2009: 417).

Undertaking a study of governance in a regulatory field, one encounters the problem that the distribution of power and the institutionalization of the process are intricately interwoven. In order to be able to separate these two aspects, a comparison of several countries is employed. Cross-case comparison, it is hoped, will reveal the difference a certain structure in the regulatory network can have on the regulatory output or which influence the employment of certain instruments by actors in the regulatory network can have. Comparison across cases allows us to see different institutional structures at work in producing new regulation as well as the role of formal and informal means to have an impact on the norm writing by certain actors. Furthermore it allows us to specify regarding different cases, if what we observe is the same mechanism in which the acting variables take on different values or if we observe fundamentally different causal pathways. In this respect, comparative case studies complement single within case analysis and gives greater leverage to the results in search of general mechanisms.

3.3 The construction of evidence and causal imputation

Evidence in case studies are based on observations which receive their relevance from the case specific knowledge the researcher has gained. The researcher is situating the observations in the larger narrative of the case which he is developing. For within case study analysis, he evaluates these observations according to their likelihood of appearance given his working hypotheses, using the Bayesian logic of inference. This method is particularly suited to interview and document data assembled for process-tracing. In the Bayesian method, the probability of

observing something is used to assess its status as evidence, which grants to an observation which is very unlikely to happen, but actually did happen, a high status as evidence for a specific hypothesis. This method is particularly useful, when one wants to distinguish between alternative hypothesis. In this vein, Bennett writes: “What is important is not the number of pieces of evidence within a case that fit one explanation or another, but the likelihood of finding certain evidence if a theory is true versus the likelihood of finding this evidence if the alternative explanation is true” (Bennett 2006: 341). Using the Bayesian method, researcher are trying to determine the probability that their hypothesis is true by comparing the likelihood of evidence appearing if their hypothesis is true vs. the likelihood of it appearing if their hypothesis is not true. There is the distinction between “hoop-tests” and smoking gun tests. Hoop tests regard observations which have to hold if a hypothesis is to be true, however, these observations do not exclude other hypothesis. Smoking gun tests on the other hand tests for evidence which with a very high probability can only be true if our hypothesis is correct, thereby excluding other hypotheses.

The Bayesian method, however, can only be used for within case comparison, not for cross-case inferences. For cross-case inferences, which will then inform Bayesian within case analysis, the researcher can use methods to evaluate correlative associations found between different variables in a cross-case comparison. There he is focusing on necessary conditions, which if absent, prevent a certain effect of happening and sufficient conditions whose presence overdetermines the existence of a certain outcome (s. Mahoney 2003: 341f). These two conditions can fall together, so that if something is necessary and sufficient, its presence will always ensure the presence of the outcome and its absence always ensure the absence of the outcome. In order to discern necessary and sufficient conditions, researchers first and foremost

build on Mill's methods of difference, of agreement and of concomitant variation⁴¹ (s. George and Bennett 2005: p.155). However, these can work well only if three demanding assumptions are met: that there is only one necessary or sufficient condition which invokes a regularity, all causally relevant variables must be identified prior to the analysis and it must be possible to work on all kinds of cases with respect to the question. For this reason, Mahoney suggests to use these methods as a "a sound way for eliminating potential necessary and sufficient causes" (Mahoney 2003:341), but he notices that you cannot positively explain processes with multiple explanatory factors with this method.

I will follow his suggestion of using the method of agreement to eliminate necessary causes. The method of agreement postulates that for a cause to be a necessary cause for an effect, it has to be present in all instances of the appearance of the outcome. We can negate the status necessary cause for a variable, if all the cases where we observe the effect don't have a certain variable in common. He suggests furthermore using the method of difference to eliminate sufficient causes. The method of difference postulates that for a variable to be a sufficient cause, it should not be present, if the outcome is not present. Thus we can negate the status of sufficient cause for a variable which is present in cases where we observe a positive outcome and those where we observe a negative outcome. In this respect, a single deviation is enough to eliminate a factor as a necessary or sufficient cause. When focusing on the interaction of different variables in a case, which bring about a result (what is called configuration of causes), the researcher needs to be sensitive to conjunctive necessity, which implies that A is necessary, but only in interaction with B and C can bring about D and the possibility that there are different causal

⁴¹ The method of concomitant variation leads to the identification of correlations, but it does not allow one to specify which variable is cause and which effect. As it is the most basic technique, measured by simple cross-tabulation and with only three values (positive correlation, negative correlation and no correlation) it will not be explained any further in the following.

pathways which can lead to the same outcome, called equifinality (s. George and Bennett 2005: 156f). Correlations identified in cross-case comparison can then be used, in order to better specify if conjunctive necessity is present and how it works and if there is equifinality (ibid.: 160).

Once the researcher has identified these configurations for his cases, he might then attempt to produce types, developing contingent generalizations about combinations of configurations that constitute a theoretical type (ibid: p.233). For these types he will seek to specify the pathways through which particular types relate to specified outcomes, linking a cluster of causes to an outcomes. In generating types, a good strategy is to divide the cases into types with the highest between variation and lowest within type variation, looking for clusters of characteristics that differentiate them. Once one has managed to produce such a typology, one can then seek to identify control cases to test one's typological theory.

3.4 The limitations of process tracing and the comparative method

Process tracing and the comparative method cannot provide us with certainty about the degree of impact a specific variable has on an outcome; knowledge which is produced by large n statistics. At the end, the researcher will be able to present a causal model for how the different configurations in the cases explain different outcomes, but he will not be able to specify which of the variables had exactly which kind of effect. In this respect, case studies are much better in identifying the scope conditions under which a causal mechanism holds, not the degree of impact single variables have (George and Bennett 2005:25) ⁴². Mahoney (2003: 350) points in this respect to the difference between linear patterns of causation captured by statistics, and configurational patterns of causation captured by case study analysis. The fine-grained, but

⁴² Cross-case comparison however, will allow the researcher to identify sufficient causes if these exist.

limited results of case studies can be used as input for statistical procedures to test if hypothesized causal mechanisms hold also for other cases, and to identify cases which are deviating from the postulated theories for future research.⁴³ The fact that I only have four countries limits the capacity of the methods of agreement, difference and concomitant variation to produce reliable results. In the last empirical chapter of the dissertation, I will seek to use the insights generated from the four cases to apply it to all member countries of the EU, the US and Canada in order to be better able to make use of these comparative methods.

3.5 Data sources: reliability and access

In order to establish the size and the composition of the ABCP market for the different countries (defined as the volume of Asset-Backed Commercial Paper emitted by conduits which are sponsored by banks of a certain nationality), I applied for and was granted a dataset by Moodys which contains the information on these questions for June of the years 1999 to 2010. I thus have 12 data points, which allow me to depict general trends in the evolution of these markets.⁴⁴ The data is rather reliable and comprehensive, due to the central position of Moody's in the process of rating the commercial papers market.⁴⁵ Individual research on specific conduits

⁴³ In order to do that, however, the statistician will have to pay close attention to achieve conceptual homogeneity between the way variables are circumscribed in the case study and the data which he is employing.

⁴⁴ While monthly or quarterly data would have been better to study the interaction between regulation and the market in a deeper way, the current data set is already proving to be a great favour by the Moody's Corporation. If these data sets, each containing information on all ABCP conduits sponsored by banks in the respective year, had to be bought, the costs had exceeded \$10000. The contract specifies that this information can only be used for academic purposes.

⁴⁵ However, cross-checking between this data source and the annual dataset for the ABCP market by Fitch in 2008 reveals that there are some irregularities with respect to the categorization of conduits. In one specific instance (Versailles LLC sponsored by Natixis), there was a sizeable component of paper which refinanced assets of Natixis which were bought for reasons of securities arbitrage. For Moody's, this amount did not seem to exceed the threshold to label the conduit hybrid, whereas it did for Fitch. This evidently relates to the problems of categorization, as different thresholds might be used by the different rating agencies to apply certain labels to these conduits. These issues reveal that we don't get a 100% clear picture of what the banks were doing with these conduits, but rather general assessments (e.g. this conduit is mostly for the refinancing of credits of clients= multiseller conduit).

was undertaken in special cases, such as Versailles LLC with the help of industry publications. Establishing the state of the banking system from 1990-2008, I am using the OECD database on banking profitability. Secondary data (such as academic texts and accounts of economic journalists) are used to identify problems of specific banking systems as well as their degree of sophistication.

I have personally collected 60 semi-structured interviews⁴⁶ with 75 people, using an interview guide developed particularly for each country built on prior document analysis. Most of these interviews were generated by attending special events on the topic of financial regulation, where I had the chance to meet potential interviewees, by e-mail requests⁴⁷ or by recommendations from former interviewees or mutual acquaintances. The actor which is persistently missing from my list of interviewees in these three countries is the finance ministry.⁴⁸ In addition I have undertaken 9 background interviews, which attained that status either due to their general nature, being e.g. about the structure of the financial market in France and the role of the banks in it, or because respondents could not go “on the record” due to the confidentiality of their work. I have also been granted access to 4 semi-structured interviews conducted in France with a banking regulator, two high officials of the accounting standards setting body in 2010, the head of securitization of a large investment bank and the finance director of another large bank. These interviews were all very close in content to my study, such that their inclusion proved valuable.

⁴⁶ Several of the interviewed were interviewed for a second time in order to clarify issues, however, these several interviews were only counted as one. 4 interviews were given to me by two French researchers working on financial regulation in France.

⁴⁷ The available public evidence on which actors participated in the regulatory debates allowed me to make sure that I am not missing crucial actors due to the constraints of the acquaintance networks of my interviewees. E-mail requests for interviews for experts which had published documents on the issue of financial market regulation for ABCP conduits were often successful.

⁴⁸ It proved impossible to get access to these actors, probably because of the political sensitivity regarding the issue of the regulation of this market (s. Handke 2011, who reports similar problems for Germany).

The interviews were semi-structured in order to deal with the information asymmetry between me as an interviewer and the experts I interviewed regarding the highly complex matter of ABCP conduits and their regulation. Being semi-structured allowed me to learn during the interviews as well as asking specific questions generated from the regulatory texts analyzed beforehand⁴⁹ Given the complexity of the regulation, the participation of several interviewees (up to three) was often helpful, because uncertainties on the part of interviewees could be cross-checked in the moment of interviewing. As some of the events of interest were a decade or more in the past, I used regulatory texts and pronouncements from this period during these semi-structured interviews in order to help the actors remember. Going over the events chronologically served the function of refreshing the memory of those involved.

The advantage of my field of study is that many experts on the rules are at the same time practitioners, which know about the impact of these rules on practice. This fact for the field of accounting stems from the large degree of professional self-regulation, where practitioners are involved in generating the rules. I interviewed auditors who were working in the technical department of one of the big four auditing networks who were actively engaged in rule setting, (former) standard setters, which have also worked as auditors and thus know the business implications, financial supervisors who were managing partners at the big four before or professors of accounting which were member of the standards setting body. This allowed me to ask those involved in actual accounting decisions regarding the link between banks and non-

⁴⁹ In order to overcome this asymmetry I have also attended a one day seminar at the True Sale Initiative (a German think tank/lobbying group for securitization) on May 15th 2011, focusing on the international and German regulation of securitization markets, which thanks to the generosity of the TSI I could attend free of charge.

banks to explain me the negotiations between external and internal accountants regarding these decisions and which difference changes in accounting standards made to these negotiations.⁵⁰

I tried with considerable success to gain interview partners from all important players in the regulatory networks in these three countries, which includes the central banks, the financial supervisors, the auditing associations, banking associations, bankers concerned with accounting decisions, accounting and law professors involved in the accounting standard setting, accounting standard setters and state officials concerned with accounting standard setting, external auditors as well as regulatory service provider for the big auditing networks. (s. Graph 1 below). In addition to these actors, I interviewed academics and politicians involved in governmental research on the causes of the crisis (Germany), economic advisors to the president (France), analysts for banking stocks (France, Germany) as well as members of the rating agencies (Standard and Poors, France, Moodys, USA) to better understand the developments in the banking sector before the crisis.⁵¹

Function of Interviewee/ Country	Germany	Netherlands	France
Central banks	X	X	X
Financial supervisor	X	X	X
auditing association	X	X	X
Banking association			X
Senior bank managers and managers concerned with accounting decisions regarding SPEs	X	X	X
Accounting and law professors involved in accounting standard setting	X	X	X
Accounting standard setters	X	X	X
and state officials concerned with accounting standard setting	X	X	
External Auditors from the big 4 auditing networks	X	X	X
Regulatory Services big auditing networks	X	X	

⁵⁰ These questions are motivated by the insight of governance theory, that in order to evaluate the changes in the rules that take place, it is necessary to understand their application in everyday practice and the problems this everyday practice posed.

⁵¹ In particular the interviews with the researchers in Germany proved to be enlightening, as certain issues which were only written between the lines in the final government reports.

Table 3.1: Categories of interviewees

In these interviews I was particularly interested which players were involved at what time in the formulation of rules for ABCP conduits and under which conditions (formally vs. informally) could they seek to influence the process. I collected multiple independent observations from journalistic sources, public documents, background interviews which I used to verify statements encountered in the interviews. The triangulation of this evidence gives me a certain degree of confidence in the reliability of my data, which is constrained by the lapse of time between the events and the interviews. Confirmation by several sources on the same issues increased the validity of certain statements. I will mostly rely on information confirmed by several sources and if there is only one source, this will be clearly indicated to the reader. Regarding the accuracy of the information I have received, I benefited from the fact that I was interviewing people centrally involved and people, which while involved stood rather at the margins and thus were closer to interested participating observers than powerful players.⁵² While powerful players might tend to overstate their own importance, the category of interested participating observers could correct these impressions. The same holds for interview partners, which might have tried to direct my research in favour of their agenda (either to hide certain facts or to use my work as a potential political weapon in the future). In general, interview data, generated by the interaction between interviewee and interviewer can generate false perceptions on the side of the interviewer, which are driven rather by his own ex-ante hypotheses than by what he is being told. In order to correct these mistakes, I transcribed the interviews and often addressed the interviewees a second time in order to make sure, I properly understood. Several

⁵² As an example, I interviewed the representative of the unions in the French National Accounting Standard Setter. As he is the only representative, his power in a body of 55 is rather limited. But as a person which was participating in all the monthly meetings over decades, he had developed deep insights into the working of the body and the factions in it.

times, I visited interviewees for a second time in order to verify their accounts and probe deeper. Lastly, I tested the accounts from prior interviews in my next interviews. When mentioning them, I would often find myself corrected by the next interviewee, revealing that I had misunderstood the initial data and was provided with a more accurate understanding. In this way I would refine and test my knowledge of the historical process. In this respect, the relatively high number of interviews, especially in the German and French case was helpful for this iterative procedure.

The entrance into the regulatory networks in the different countries was different, in line with the different structures and processes in these networks, and thus provided itself important information. In Germany, where the regulatory elite is much more splintered geographically (Frankfurt, Duesseldorf, Berlin) and the standard-setter is not in- but exclusive, interviews had to be more often organized by e-mail requests. In the Netherlands, which in terms of geographic location of the elite provides a middle ground, the collection of interviewees was a mixture of e-mail requests, recommendation of former interviewees and acquaintances. In France, due to the location of the regulatory elite in one city (Paris) and the high frequency of meetings in the inclusive standard setting body, interview collection by referral proved to be the predominant way.

Chapter 4: KEEPING IT HOT: WHY MAINTAINING UNCERTAINTY OVER FRAMING IS SOMETIMES THE ONLY THING TO DO

“One thing that struck me ...was the fraction of financial innovation with "innovation" in quotation marks over the last quarter century that has apparently not been for productive purposes but rather for the purpose of avoiding various forms of regulatory or legal control” (Charles Fergusson, director of Inside Job, in Debating Innovation 2012 Vol. 2(1): pp. 25)

4.1 Introduction

Economic sociology has recently shifted from the problem of value to the problem of valuation (Stark 2000: p. 5, Stark 2009: 32, Stark 2011, Lamont 2012)⁵³. Such an approach is bracketing the nature and generation of value, which has been the subject of classical political economy and instead focuses on practices of valuation. I follow this approach in this chapter, but reinsert the focus on the appropriative processes related to such valuations, i.e. the political economy involved in such acts of measurements. Including this aspect, we can better understand the existence of special purpose entities, and the problems they pose for accounting standard setters. As a product of regulatory arbitrage, special purpose entities are structured to never appear on the balance sheets of the financial conglomerates which sponsor and support them. The risks they pose are thereby never becoming part of the valuation of these financial conglomerates in financial markets, whereas the fee income they generate for the bank which sponsors them are. In this chapter I focus on the struggle between auditors and audited over the inclusion of these special purpose entities in the balance sheets of financial conglomerates, and thereby the appropriate demarcation of these conglomerates from their environments in accounting. Focusing on the interpretive fights involved in the construction of conglomerates, I

⁵³ The most recent literature has pointed out that when we are talking about valuation, we are actually talking about two processes, “valuation practices (giving worth or value) and evaluative practices (assessing how an entity attains a certain type of worth).” (Lamont 2012: 205). The object of study in this chapter, the demarcation of conglomerates contains both aspects.

build on and extend theories proposed by the Social Studies of Finance (in the following SSF). In contrast to this theory which emphasizes the pacifying function of calculative devices in moments of negotiation and which sees the work of the creators of such calculative devices in the reduction of transaction costs, we observe in the case of accounting standards for special purpose entities the construction of a calculative device that is increasing transaction costs and heating up the debate. These standards refuse to clearly delineate the procedures according to which measurements will be made to establish the perimeter of consolidation of conglomerates. How can this deviation from the theory be explained?

Once we embed standard setting in the political arena of everyday auditing practices to which it responds, the reasons for this refusal become apparent. Gaining a better understanding of these developments requires us to ask how the profession, for which accounting standard setters are writing the rules is creating value added for the organizations which hire them. Financial conglomerates are created through performative speech acts in accounting and this and the importance of the accounting numbers for the future survival of the conglomerate is making acts of accounting manipulation profitable. In line with this fact, auditing and taxation consultancy are now the main profit-generating activities for auditing networks (s. Coffee 2006). According to Julia Black, “the opportunistic use of rules is prevalent in financial and business regulation, and supports a large contingent of professional advisers.” (Black 2002: 243, s. also 247). Regulatory advisors aid their clients in the creative compliance with regulation which is made easier, as what is being regulated “are artificial, legal and financial constructs” (ibid). This statement by Black particularly holds for structured finance, where regulatory advisors structure transactions to achieve a certain regulatory treatment.

As consultants, accountants are optimizing the taxation and the accounting representation of their corporations to financial market investors (s. Fooks 2003, Sikka and Willmott 2009). Such optimization involves the structuring of business transactions that they end up in a grey zone of accounting standards, by inventing new legal constructs, which are structured such that they “possess only some of the features of the paradigm case or cases but not others” (Black 1997:11). In this territory insufficiently defined by the rules the audited can easier impose themselves on their auditors. Reaching that zone is creating value added for corporations as they can optimize their representations in financial markets. At the same time it contradicts the goals of accounting standards to permit the truthful representation of corporations for these markets. These problems in auditing with which accounting standard setters are grappling thus directly stems from the way value added is created via valuation. Off-balance sheet special Purpose Entities, used in securitization by banks are a clear outgrowth of such consulting activities which help banks to move assets legally off their balance sheets in order to minimize the regulatory capital charges they face while maintaining maximum economic exposure to these assets.

The formulation and implementation of accounting rules is a fight over the space of interpretation for the preparers of financial statements, which has large political economic consequences (s. inter alia Hoarau 2010, Chiapello 2005 who emphasize the controversial goals different groups in society pursue with accounting standards). This fight takes place in the realm of the calculative rules which are put centre stage by the SSF. If we don't pay attention to these calculative rules, how they are formulated and interpreted, we don't capture an important site for political-economic contestation in current capitalism. In the case of performative speech acts such as accounting for conglomerates, questions of political economy are not only represented in communication, but communication is the level at which they are fought out. Studying these acts

and the rules that govern them, we need to move from the apolitical Social Studies of Finance to a study of practice which embeds the rule making of those creating calculative devices in the negotiations regarding the application of these calculative devices, in our case accounting decisions between the auditors and the audited.

4.2 Accounting through the lenses of the Social Studies of Finance: The concept of performativity, calculability and disentanglement

The social studies of finance is a relatively recent strand of social research. Inspired by science and technology studies, the focus is put on “the material devices, procedures, routines, rules and design features that make markets what they are” (MacKenzie 2006:275), which provides a fertile ground for a more nuanced debate of financial markets that extends above demonization or admiration. The focus is on the calculative preconditions of exchange which allow a market to function, emphasizing the need for the calculability of goods for exchange to take place. The constructivist research program of the Social Studies of Finance points out how profits, risks etc. are constituted by their calculation. The calculation of objects is seen as a the characteristic of economic calculation, and the sociology of calculation has to take into account the “weltkonstituierenden”⁵⁴ character of these calculations, focusing on the question of what is included and what is excluded in these calculations (the frame). It is the strength of SSF to point out which fundamental, constitutive role accounting plays, that the generation and processing of signs is indeed a practice which generates reality (Kalthoff 2007a: 152). Instead of highlighting the weaknesses and limitations of economic theory as is common in other strands of economic sociology (paradigmatic Granovetter 1985), these authors are interested how economists contribute to the formatting of calculative devices in markets which frame products as

⁵⁴ literal translation: world-constituting

commodities (Callon 1998a, b). In SSF, economists are broadly defined as all those seeking to generate rules for calculation, also including economists “in the wild” such as accounting standard setters (s. Callon 2007:351). Economists are seen as crucial actors for the smooth functioning of market exchange, as they generate the calculative frameworks within which the exchange will take place (s. Gill 2009: p.59). Their rules generate the agreement on what to include and what to exclude in a given moment, specifying how to disentangle a good from its environment. These frames are used to cool off situations of negotiation. This cooling of calculative situation is for Callon the fundamental role economics plays in performing the economy.⁵⁵ By clarifying *ex ante* in these situations what needs to be taken into account in the calculation, framing is understood to create a space “which brings together the different parties and allows them to harmonize their desires” and thus to come to a mutually agreed exchange (Callon 1998b: 250). In cold situations of negotiation, the procedures for analysis are agreed upon, and precede the negotiations. Hot situations, in contrast are characterized by Callon as hybrid forums, where the definition of the issue and the negotiation over how to deal with the issue take place at the same time (see for the example of externalities Callon 1998b: 259). Without calculative devices, such as accounting (Callon 1998b: 29), which disentangle goods from their environment and thereby permit to specify acceptable prices beforehand, market transactions would take much longer and have much higher transaction costs. While these are very important theoretical advances in economic sociology, the current shortcoming of this approach is that it pays too much attention to the internal configuration of models and does not pay sufficient attention to the different social actors involved in the sequence of calculation and

⁵⁵ “If they (economic agents, M.T.) manage to become richer it is because, on the contrary, they were cooled, reduced and framed, particularly by economics!” (s. Callon 1998a: 50).

their opposing interests (for a general critique of the SSF regarding the exclusion of the social power plays surrounding modes of calculation in the analysis, s. Mirowski and Nik-Kah 2007).

To understand these opposing interests and the reflexive relationship between the accounting rules and the behaviour of corporate actors it generates, we first need to appreciate the material consequences the representation of corporations in financial markets has for them.

Financial accounting is a central regulative device for corporations that link them to their creditors and shareholders in financial markets.⁵⁶ It produces financial ratios (such as equity over liabilities) which are used by financial investors to determine the interest rates these conglomerates will have to pay when borrowing money. It is also used by share analysts to determine the value of the stock of such a corporation. Financial accounting numbers thus have a high impact on the future viability of the firm, as the cost of credit itself impacts the profitability of future operations and share prices partially determine the vulnerability for take-overs.

It is in this sense that financial accounting is indeed a performative act in the sense Donald MacKenzie gave the term.⁵⁷ Inspired by John Austin's work on performative speech acts (such as in the vow of marriage, which creates a legal bond, s. Austin 1962) and the work by the sociologist Barnes (1988) on self-validating feedback loops, MacKenzie has focused on the impact representations of the world have on the world thus depicted, in particular models of financial markets and the impact on their functioning. Financial accounting as a representation of

⁵⁶ Since the installation of external auditors assessing the wealth of a corporation and its likelihood of survival in the next year (what is called "going concern"), accounting for corporations has been first and foremost a means for the external creditors of the firm to assess the future viability of the firm (s. Chatfield 1974:82) and to gain the legal right to take action if their credits are threatened by failure of the corporation. Debt covenants in credit contracts specify that if the financial situation according to accounting numbers deteriorates to a certain level, creditors gain control over actions of the corporation. As Frankel and Litov put it, "Debt covenants reduce shareholder moral hazard by providing bondholders with additional rights prior to severe financial distress" (Frankel and Litov 2007: 3).

⁵⁷ MacKenzie developed the notion of performativity in his work on the Black-Scholes formula and the impact it had on derivatives trading (s. MacKenzie and Millo 2003, MacKenzie 2006). He found that the Black-Scholes formula provided a calculative device for the value of derivatives, which helped lift derivatives trading from the realm of gambling to the realm of a respected trade. Furthermore, once the model was introduced, the prices of derivatives started to behave more in line with the prediction of the Black-Scholes model. This is where the performativity of the model resides, that it made reality look more like the model.

the state of a corporation is also “an engine, not a camera” in MacKenzie’s sense (MacKenzie 2006) in that it not only represents the financial situation of a firm at a given point in time but that this information itself will have an impact on the financial situation of the thus depicted firm in the future⁵⁸.

This performative aspect of the measurement of economic activity through the application of accounting rules leads to a change in economic activity itself. Borio and Tsatsaronis refer to this fact in accounting as the ‘endogeneity of value’ (Borio and Tsatsaronis 2005: 15), arguing that the way value is accounted for in balance sheets guides the production of such value⁵⁹. In the following quote, we can clearly see how standard setters themselves are grappling with the performativity of financial statements and how it endangers the truthful representation of the economic situation in them.

Senior accounting standard setter IASB: “there is an entire group which lives from... what do you have as an argument when you sell financial products? You have two arguments, the taxation first. So that you can sell any thing you want, as useless as it is if it brings a tax advantage. Second, that the accounting method allows you not to do that or this. And this is bizarre for me as an accountant. ... so with taxes I can understand, it is about money, but with the accounting advantages, this is only about the representation. That are only numbers in colons, this is much harder to understand if you see what I mean.” (Interview Paris 01/21/2011)

This reflexive feedback loop in the interaction between business and accounting rules is driven by the conflict of interest between those preparing financial statements and those using them, as Borio and Tsatsaronis describe: “whenever the interests of those obtaining funds and those providing them do not coincide, there is an incentive for the users of the funds to withhold or misreport information, to the extent that they can further their own interests” (Borio and

⁵⁸ Botzem and Quack make a first step to such an analysis when they point to the structuring impact financial reporting has. “Financial reporting shapes the categories through which corporate governance actors perceive and evaluate each other; thereby also influencing strategies and decision-making” (Botzem and Quack 2005:1).

⁵⁹ Enron has driven this principle to its extreme (s. Hoffmann and Luedenbach 2002)

Tsatsaronis 2005: 12).⁶⁰ These different interests involved in the application of accounting rules are personified by the accountants, lawyers and regulatory advisors of the banking conglomerate who are paid to optimize accounting decisions and the auditor who is paid to verify the correctness of the application of the rules and vouches for it with its signature. Their dialogue is shaped by the general properties of rules, which by definition are over- or underinclusive, indeterminate and therefore subject to interpretation by those applying it (Black 1997: 10).⁶¹

Scholars in the tradition of SSF have been aware of the performative aspect of accounting, but have ignored the conflict of interest which expresses itself in the production of accounting numbers. Instead, they only treat them as an input into the models of calculation they are interested in. An otherwise excellent study on the impact different credit risk models on credit decisions by banks exemplifies this theoretical disposition (s. Kalthoff 2007a, 2007b). Kalthoff emphasizes that different models generate different values for the perceived riskiness of certain activities. This fact can generate different economic realities, as credit provision is regulated according to these models (Kalthoff 2007a: 156). He acknowledges that banks, when observing companies for whom they consider offering credit, are aware of the fact that these companies have manipulated their numbers in the most beneficial way, but he does not problematize this fact. To him, these numbers and the way they are employed by bank analysts in their risk analysis constitute the corporation anew. This proposition stems from his theoretical premise that “a fact is only realized in its presentation” (Rheinberger 1997, 2000, as quoted in Kalthoff

⁶⁰ Banking conglomerates are especially prone to be subject to the “endogeneity of value” due to the importance of their financial ratios for their business model, which is primarily based on low interest rates to operate profitably.

⁶¹ As with contracts, rules can never envision all possible states of the future, which generates their indeterminacy. In that certain situations will only partially fit the fact pattern described in the rules. They are formulated with a certain intent (what is often called the spirit of the law), but their concrete formulation (the letter of the law) can lead to the application of the rule to circumstances not envisioned (over-inclusiveness) or miss important circumstances which according to the intent of the rule should be included. Due to these facts and the ambivalence inherent in the meaning of words, these rules are subject to interpretation of those applying the rules, which leads us back to consider the interests and conflicts in the process of applying these rules.

2007a: 153) and “objects are generated only in the procedure of their calculation” (Kalthoff 2007a: 153, translation M.T.).

What Kalthoff neglects however is the work that those corporations which are constituted anew by these analysts put into the production of the numbers these analysts use. Accountants of the corporation seek to exploit ambiguities in the rules to beautify the balance sheets of their employers. The numbers, manipulated in this way by the corporations makes deciphering work by credit analysts in analyzing the reported balance sheets necessary. This requires a degree of accounting sophistication that is not always present (interview auditor teaching the meaning of accounting standards to credit analysts, 02/21/2011). Credit analysts need to be perpetually updated on new accounting techniques e.g. for off-balance sheet financing⁶². This perpetual game of “innovations” in accounting techniques to beautify balance sheets and the catching up of credit analysts bestows the value on these innovations and injects the dynamics into regulatory arbitrage. These acts of arbitrage offer a temporary possibility for corporations to manipulate their balance sheets without being detected by bank analysts, and thus improving the credit conditions for the corporations until the latter are updated.⁶³

In this respect, internal accountants exploit the increase in the supply of numbers and information credit and equity analysts have to deal with in recent decades. As Luhmann (1991) has pointed out in his observations on the sociology of risk, the increasing complexity in financial markets leads to attempts of simplification by external observers (p. 188f). Financial ratios, such as the debt to equity ratio which are the result of simple summarizing statistics are such means of simplification. But, relying solely on such statistics means to accept its underlying

⁶² These services are provided by the large auditing networks, which ironically also sell their services to structure such off-balance sheet activities (interview auditing manager large auditing network, Duesseldorf. 02/21/2011)

⁶³ The financial crisis from 2007 was partially caused by such blindness of financial analysts to the amassment of credit-risk in the banking sector via off-balance sheet financing techniques (such as their securitization business), which was only corrected once these risks hit the balance sheet of banks.

representation of the corporate entity as correct, ignoring all the exploitations of interpretive spaces of accounting standards at the margins.⁶⁴ Asked if the widespread manipulation of balance sheets stemmed from the costs of debt or the value of shares, a senior accounting standard setter at the IASB responded:

«it is the two of them and it comes from the lack of culture at the financial analysts regarding balance sheets. ... They are not good, there are some good ones, but some are incredible. The financial analysts are not necessarily those guys which know how to read balance sheets.

interviewer: and they want to reduce reality to something which they can easily grasp
standards setter: absolutely.” (interview Paris 01/21/2011, translation M.T.)

One example of an off-balance sheet financing technique, which uses SPEs and exploits the habit of financial analysts to simplify their work by relying on summary statistics is leasing. While liabilities incurred through leasing are often not recorded in the balance sheet of the conglomerate which is taking the lease, they do appear in the annex of the financial statement. But being placed there means that they often escape the attention of financial analysts and thus do not affect any more their decision-making. This also holds for credit analysts of banks, as was explained by a German accounting professor analyzing the financing models of German SMEs.

Accounting professor: Many German firms have a high degree of external financing and if this is part of your business model, then leasing is a very good idea. Normally, this should not play any role regarding the decision to grant a credit or not, as credit analysts are asked to also look into miscellaneous liabilities. But the problem is that many addressees only look at the calculation of losses and gains and the balances, they don't look into the annex. They are fixated on the financial ratios. (interview Wuppertal 30.06.2011, translation M.T.)

⁶⁴ Such a behaviour of simplifying complex decisions when aggregating and distilling information has been identified by Vaughan (1996) as one of the leading factors in the fatal launch decision of the Challenger.

This obscurity of annexes⁶⁵ and the fact that financial analysts often engage in a superficial analysis of balance sheets based on simple math, rather than questioning the production of the numbers they use for their calculations is the factual basis for the demand by corporations for accounting advice, demand which is satisfied by auditing networks and lawyers. Such advice for creative compliance has been especially high when the determination of the size of conglomerates is concerned, exploiting the legal uncertainty surrounding their exact size.⁶⁶ Only if we take into account the opposing interests between analysts and corporations (supported by regulatory advisors), can we understand why principles based accounting rules in general and the rule SIC 12 by the International Accounting Standards Setting Council (IASC) in particular do not conform to the function SSF-scholars ascribe to calculative rules, which is “to cool off situations of negotiation”.

Accounting standard setters have refused to unambiguously specify the calculative procedures to disentangle the conglomerate from its environment⁶⁷, instead granting the final say to the professional judgment of the auditor.⁶⁸ They have only provided indicators (such as who holds the majority of risk and rewards) and principles (economic substance is more important than legal form) and delegated the final decision making to the auditor, thereby inhibiting the cooling off of the dialogue between auditors and the accountants of the audited firm. In order to deal with the “endogeneity of value”, the standard setters of the IASC have decided to keep the

⁶⁵ This ignorance regarding the annexes is also structurally promoted as annexes are ever-growing and difficult to evaluate in their information content (s. Hoffman and Luedenbach 2007).

⁶⁶ The most famous example of such balance sheet ‘window dressing’ has been the use of repurchasing agreements by the large Wall Street Investment banks to lower the size of their balance sheet exactly before the date at which they had to hand it in to the SEC, only to augment it a few weeks later again (s. Ekkenga 2011).

⁶⁷ The first standard setter to do so was the International Accounting Standards Council in 1998. The French Accounting Standard Setter followed suit in 1999, the Dutch one in 2001, the American one in 2003.

⁶⁸ He has to consider the situation in its entirety and weight the distribution of risks and benefits emanating from a special purpose entity. If he finds that one conglomerate bears the majority of risks and rewards from that special purpose entity, the SPE should be consolidated on the balance sheet of that conglomerate, see the interpretation SIC 12.

negotiating situation between auditor and audited open and rather undefined. Rather than developing unambiguous calculative agencies, accounting standard setters have sought to limit the strategies of manipulation by the audited through maintaining uncertainty over the practices of disentangling. They do so in order to disconnect the reflexive relationship between regulation and the financial services being “produced” which stems from the malleability of financial “products” and is exploited by regulatory advisors and financial and legal engineers.

Financial engineers start from scratch when they design these products, in contrast to civil engineers which have to take the physical environment into account. Therefore, they have much more degrees of freedom in the way they can structure the final product in order to serve the needs of the customer (background interview Rating Agency New York, 03/10/2011). Such structuring employs the fundamental idea of financial engineering in order to evade costly regulation.⁶⁹ Regulation often puts an additional cost on an operation, and regulatory advisors will then set out to engineer a synthetic way of generating a similar cash flow, which achieves the same result but circumvents the regulation. In the case of off-balance sheet financing, regulation is applied to activities recorded on the balance sheet of a financial intermediary. Regulatory advisors set out to avoid the recording of business activities on the balance sheet of the corporation, while generating the same cash flows. This structuring activity is the foundation of regulatory arbitrage using special purpose entities. Not seeing this aspect of arbitrage, and instead only emphasizing market arbitrage is possibly one of the greatest shortcomings of finance theory, which paradoxically provides exactly the tools for such activity. It is also a major

⁶⁹ The fundamental idea of financial engineering is reverse engineering, to replicate any kind of cash flow from a given financial contract synthetically by recombining different kinds of other contracts. For example the Black-Scholes formula is synthetically reproducing an option, thereby establishing a price for that option. For a good introduction into these techniques, s. Neftci 2004.

weakness of SSF, which focuses on market arbitrage as the main mechanism linking models and economic realities, but has developed no notion of regulatory arbitrage.

Of course such attempts at circumvention via financial engineering are costly, as lawyers, auditors and regulatory advisors need to be paid. But as long as the final margins are positive creative compliance is rational for financial market actors. If it were only about moving assets off-balance sheet, this can be achieved by simply selling them. But this means giving up on any future benefits flowing from this asset. The optimal sale involves the maximum exposure to the positive benefits of the asset, while gaining derecognition from the balance sheet, thereby shrinking financial ratios. This was well captured by another senior auditor and accounting standard setter working with the IASB, when asked about the goals of accounting policies and the role of law firms in it:

Senior accounting standard setter IASB 2: I mean set out your accounting objectives, if you will, and if your objective is to recognize something as a sale, then you say, alright, figure out how to make this a sale, and really the sort of bonds that is doing this, is how do you make this a sale with as many strings attached as you can, you know you want to retain as much money, interest as you can, without jeopardizing the objective of treating it as a sale, and that is **the clever balancing, where you say, where is the tipping point, where do you say that is already not anymore a sale**

Off-balance sheet activities of a conglomerate are defined by their dependence on the accounting decision, moving up until the tipping point but not overstretching it. Rules-based accounting standards make this work of creative compliance easier, as they provide exact numbers that guide the decision making. Cut-off lines define after which point, for example, an asset can be deemed as sold and is no longer part of the balance sheet of a corporation. These cut-off lines make the success of structuring activities to achieve desired results much more predictable.

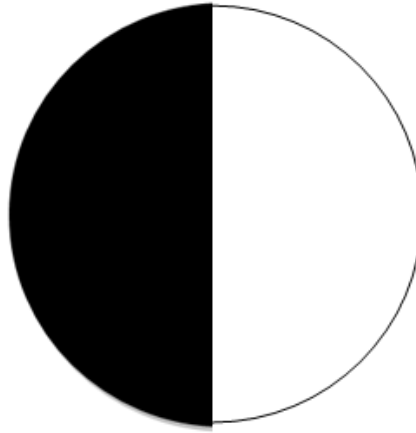


Figure 16 Accounting Standards following a legal form approach

In that approach, the indicators determining the status of an asset on or off the balance sheet clearly demarcate the balance sheet. What is deemed as an asset (here in white) is separated by a clear bright line from what is not. In this approach, if there is the lack of a legal indicator which defines an asset's owner in legal form, there is no possibility for it to end up on the balance sheet of a corporation, even if it owns the assets in terms of economic substance.

Instead of providing such clear guide lines, which exactly delineate the off- from the on-balance sheet, standard setters have, with the help of a principles based standard installed a grey zone, in which what before was outside of the balance sheet due to the circumvention of legal indicators is now in a grey zone, as it might or might not contradict the principles established to determine the affiliation of an asset as part of a corporation. In this grey zone, the auditor and the audited negotiate over the question if the asset is part of the balance sheet or not according to the economic substance of the relationship of a corporation to that asset.⁷⁰ The decision for the derecognition of an asset from the balance sheet involves an analysis of the parties who are

⁷⁰ The International Accounting Standards pursue such a principles based approach. They define an asset as "a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise." (IFRS framework) In order to fully derecognize such an asset from one's balance sheet (IFRS 39), the firm needs to get rid of substantially all the risks and economic benefits of these assets. If that is not the case, but only parts of the risks and benefits are externalized, the parts which remain need to be put on the balance sheet.

exposed to the future benefits and risks of an asset, independent of its legal owner. This analysis of the risks and rewards which represents the economic substance of the relationship is creating a grey zone of negotiation, where before legal indicators of ownership precluded any discussion. Now, auditors and audited need to come together to a common interpretation of the distribution of risks and rewards of an asset to decide upon derecognition.

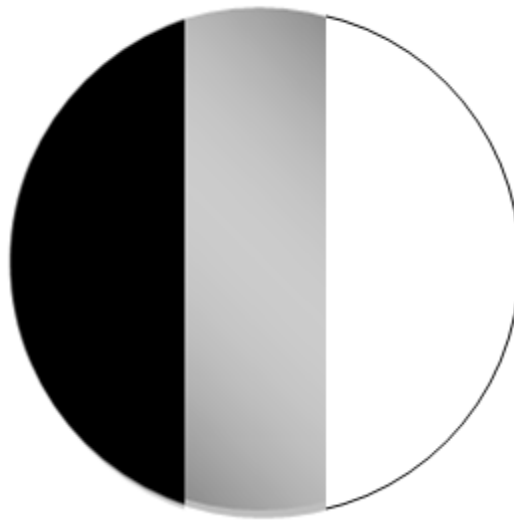


Figure 17 Accounting Standards following the economic substance approach

With respect to the construction of special purpose entities this appreciation of economic substance without a checklist makes a big difference, as clear rules make it easier for those structuring to secure off-balance sheet status. This leads to the paradoxical situation that the clearer you are in your rules, the more evasion you will get.

interviewer: there are like a million ways to structure special purpose entities

Senior accounting standard setter IASB: exactly and the more precise you are the more you get evasion. (interview Paris 01/21/2011)

Standards following a legal form approach provide clear guidelines for structuring and will lead to the derecognition of an asset or an SPE, even if the conglomerate is still exposed to it in

economic substance. In contrast, a principles-based standard empowers the auditor to challenge these constructs by lawyers which are constructed to avoid regulation (s. Black 1997: 104), as the economic substance of these constructs is similar to the product it is seeking to reproduce synthetically. They thereby deny certainty to those structuring regarding the final decision of the auditor (Black 2008: 16), as these standards only provide guidance to accountants at a high level of generality, using qualitative terms, expressing the reason behind the rules and suggesting to the accountant in which way he shall undertake his analysis (Black 2008: 13). These two different styles of accounting standards can make a decisive difference in the delineation of conglomerates, which is of particular importance, as the size of these entities is identified according to these accounting standards and cannot be read off from any other source.

4.3 The performative accounting act of delineating a conglomerate

Conglomerates are formed by a parent company which controls subsidiaries via shareholding or contractual clauses.⁷¹ Auditors seek to provide financial market participants a “true and fair view” of the business activities and risk exposures of the conglomerate (Walton 2008) by merging the different companies judged to be controlled by one parent company into one consolidated balance sheet. The performative aspect of this accounting exercise stems from the fact that the exact size of the conglomerate, how many subsidiaries are included in it, is not determined by legal ownership (and thus cannot be read off from legal registers), but by the accounting exercise itself.⁷² Conglomerates in this sense are an ambiguous organizational form.

⁷¹ As an organizational form they came into being in 1890 in the US, when companies were granted the right to hold shares in other companies and thereby to control them (s. Perrow 2002 for a critical discussion of this development for the American Economy). The conglomerate became the dominant form of business enterprise in the US since the turn of the century (s. Strasser and Blumberg 2011: 8, Fligstein 1990, Roy 1997), and since the 1970s in all of the developed world.

⁷² The recent shift of the Deutsche Bank conglomerate for its consolidated financial accounts of 2008 from US Generally Accepted Accounting Principles to International Financial Reporting Standards could not make the

In legal terms, they are a network of organizations but in economic terms they are one business unit.⁷³ Accounting rules, as opposed to corporate law have to determine if the relationship between cooperating firms equals a conglomerate, i.e. if the observed contractual and business relationships between the firms justify it to speak of a parent firm and its subsidiaries. The decisive question is whether the parent company controls the subsidiary such that it has no latitude in choosing its own strategy. In deciding this question, the conglomerate is produced through a performative speech act. Accountants delineate the borders of a „fictional jurisdictional unit“, which does not exist in legal terms (s. Claussen and Scherrer 2011: 1021)⁷⁴. The determination which entities have to be taken into account, the question of categorization is where much of the political fight between auditors and audited takes place. If the audited can manage in the exercise of categorization to exclude disadvantageous corporations which worsen the equity ratio or include advantageous corporations which improve it, the audited has gained great leverage over the process of calculation of financial ratios by financial analysts. This leverage is especially strong as there is no other source from which financial analysts could determine the size of the conglomerate, given that this organizational form is created exclusively through a performative speech act in accounting.

relative indeterminacy of the actual size of a conglomerate clearer. The balance sheet in IFRS was 2.202 trillion Euro, whereas under US GAAP it were merely 1.030 trillion. (s. Ackermann 2009: 22)

⁷³ Unfortunately, discussions in economic sociology and organizational sociology have often been blind to this distinction between legal framework and economic reality existing within the same form of organization, instead discussing networks of organizations and hierarchical organizations as two distinct opposites of possible forms of organization (s. DiMaggio 2001). Being concerned with defining and proving the existence of a third form of organization, their definition of networks of organization excluded conglomerates proper and could only capture formations where control by the parent company is not clearly established (s. Podolny and Page 1998: 59⁷³). But even for such heterarchical organizations, researchers now perceive the need to inquire how these organizations can be held accountable (s. Stark 2009: 202ff) given that their shifting boundaries have been linked to attempts to appropriate unpaid labor from their customers (s. Stark 2009: 208). These observations suggest the need to make organizational boundary drawing our unit of analysis.

⁷⁴ Conglomerates are the prime example for those accounting scholars who are taking a constructivist approach to accounting in pointing out that accounting generates economic entities, such as the group. “Obvious examples are economic entities that get visible only through accounting, namely groups.” (Zimmermann et al 2008: 11, quoting Borger 1999, Hines 1988)

Banking conglomerates have great incentives to structure relationships with corporations which they control in economic substance in such a way that they don't need to be included in the consolidated accounts of the parent company. The importance of financial ratios for determining their costs of borrowing and core capital requirements which are applied to consolidated balance sheets of banking conglomerates are the basis for these incentives. Banking regulators request banking conglomerates to hold a certain amount of equity in accordance with the risks recorded in their balance sheets. Such imposition of regulatory charges on risk taking limit the profitability of banks, as only exposure to risk will allow financial corporations to generate profits. This fact and the impact of the representation of risk in the balance sheet on costs of credit are the factors motivating attempts of operating off-balance sheet, exposing the financial conglomerate to more risk than it officially records. In such balance sheet delineations, financial conglomerates gain exposure to an asset but refuse to account for the risks these assets pose. If these losses materialize, they might face bankruptcy, the costs of which exceed the private costs of bankruptcy. Financial conglomerates, by exploiting the interpretive space inherent in accounting rules to their advantage are in this way constructing a negative social externality, which leads to a privatization of profits in good times (when upside risks materialize) and a socialization of losses when negative risks do. The pinnacle of these attempts of balance sheet manipulation concerning the size of conglomerates is the use of off-balance sheet special purpose entities, in which conglomerates are hiding assets and/or liabilities from their creditors and shareholders which nevertheless remain under their economic control.

4.4 The legal engineering of Special Purpose Entities

The case of engineering special purpose entities for securitization is an exemplary

application of the principles of financial engineering in the realm of corporate law. Regulatory core capital requirements for assets on the balance sheets of banks led to attempts to synthetically generate cash flows as if these assets were still owned by the banks, while avoiding their costly presence on the balance sheet of the banking conglomerate. The contractual structure between the investors, the special purpose entity and the sponsoring bank guaranteed that the sponsor of the purpose entity would absorb most of the revenue emanating from the credits held in the special purpose entity, thereby synthetically engineering the cash flow. The banks undertook all the business activity of the SPE for fees and provided liquidity guarantees in case of the SPE experiencing difficulty selling its short-term debt, thereby swapping the exposure to the assets to an exposure to the SPE (Gorton and Souleles, 2007). At the same time, the relationship between special purpose entities and banking conglomerates was structured in such a way to avoid even the possibility of consolidation on the balance sheet of the bank, transforming the special purpose entity into an “orphan company” (s. PwC.2005:36). To ensure that the SPE was not consolidated as a subsidiary of the bank required the structuring of the relationship between banks and SPEs in contraposition to the standards for consolidation of conglomerates.⁷⁵ In the 1980s, when SPEs for securitization were developed, this meant to avoid any capital link or daily interference with the special purpose entity by the bank. Avoiding indicators of control in legal form, while maintaining control in economic substance required a shift of control into the contractual realm, where with the help of contracts all relevant actions by the SPE were pre-specified, putting the SPE on a contractual “auto-pilot.” These “autopilot mechanisms” specified that SPEs could not sell or buy assets on their own but that the investment advisor (the bank) made the investment decision (these are called service level agreements). Furthermore, banks

⁷⁵ Before 1998 in the US and Europe, the rules for consolidation in accounting terms, maintained that a company needs to consolidate a subsidiary company in which it holds the majority of shares and/or controls its business strategy. Accounting norms stated that the control of the business had to be visible in the daily operation of the firm.

usually held no shares in the SPEs nor provided any other capital for them. This legal engineering led to very specific organizational structure for SPEs. “In short, SPE’s are essentially robot firms that have no employees, make no substantive economic decisions, have no physical location, and cannot go bankrupt.” (Gorton and Souleles 2007: 550)

Due to the minimal equity of SPEs, made necessary by the requirement that the bank could not provide equity to the SPE, these robot companies have no capacity whatsoever to deal with a deterioration of the assets. In the market for medium and long term securities, where SPEs issued securities with at least one year maturity to refinance their assets, the credit risk was transferred to investors. In the case of short-term Asset-Backed Commercial Papers, papers with a maturity of less than one year and usually less than 90 days, the credit risk was only legally transferred to investors through a contractual fire sale function. If the credits in the balance sheet of the SPE deteriorated to a certain degree, all assets were to be sold and the remaining money to be distributed to investors. In economic substance, however the risk of credit deterioration remained with the sponsoring bank which had granted a liquidity facility to the SPE, in case there was a problem with the market refinancing. Given that Asset-Backed Commercial Paper had such a short maturity, beginning problems of credit deterioration, which did not yet trigger the fire-sale would lead to a refusal of investors to buy ABCP from this conduit, essentially forcing the bank to step in which led Acharya, Schnabl and Suarez (2009) to call this financing technique “securitization without credit-risk transfer” and Gorton and Souleles (2007) to speak of a collusion of investors and banks against the regulators to generate a risk-free asset. The orphaning of credits and their risks into the balance sheets of special purpose entities meant that credit risk was building up in the system to a much larger degree than preventive measures were taken to deal with the possibility of the actualization of these risks. This logic reached its apex in

Asset-Backed Commercial Paper Securitization, in which banking conglomerates were maintaining exposure to credit risks in economic substance, while transferring it in legal form. Instead of distributing the risks into financial markets, this form of securitization concentrated risks off-the balance sheet of banks, returning on the balance sheets of banks in case the assets deteriorated. Banking conglomerates did not need to account for these risks via capital charges, if they could avoid consolidation. At the same time the risk exposure that was transformed into fee income improved their financial ratios and their evaluation in financial markets. As financial accounting numbers force conglomerates into a relentless comparison in terms of their valuation in financial markets, such acts of regulatory arbitrage give certain conglomerates a cost advantage by presenting a better image than is real. As these acts of regulatory arbitrage are legal, they become systemic once the practice spreads.

4.5 The tyranny of financial ratios and systemic balance sheet manipulations

The ignorance of credit analysts regarding the possibilities to manipulate financial ratios in accounting makes attempts by single banking conglomerates to push assets and debt off-balance sheet systemic, as the comparison of conglomerates is built on these financial statements. This trend of pushing assets and liabilities off-balance sheets to to fare better in the “beauty contest” of financial markets (Keynes 1936) has standard setters concerned. This becomes evident in the following statement by a former standard setter at the International Accounting Standards Board, reflecting on accounting policies:

well, you know regulated industries in financial markets have several masters to serve. ... They try to overcome regulation, which is especially impregnating, because there is a tyranny of financial ratios. And you do whatever it takes to have good financial ratios. Even the best heads make things which are completely unreasonable. It is a pity to see that because the enterprises are pushed to make mistakes in order to respect their ratios. So they say, listen I cannot put that on my balance sheet, that will

add debt and so it will deteriorate my financial ratios. So if I don't put it there, I am a big man. I have a good balance sheet. But of course, given that you have those things outside of it. (interview Paris, 01/21/2011)

These performative aspects have a systemic impact on accounting policies, as the one who is reporting everything according to the rules and is not seeking to improve his balance sheets by pushing the interpretive margins of accounting rules will be treated comparatively worse in financial markets. This threatens the function of accounting to represent reality, as becomes clear in the following remarks by the same Senior accounting standard setter

“So they confound the image with the reality, and if you consolidate everything you need to consolidate, your balance sheet is worse, looks worse and you look like a bad manager, and this is the one who has done the things correctly. This is a problem, this is an image, and this is why I told you before, even if I was joking, when you said « an advantage », if having accounting that does not reflect the reality is an advantage that evidently forces *not to represent reality*.” (interview Paris, 01/21/2011, translation M.T., emphasis mine)

The fact that in a complex environment, simple numbers will be used to assess corporations forces them “not to represent reality”. And such loopholes in accounting and banking regulation guide, and need to guide the behaviour of banking conglomerates, if they want to persist in a competitive environment. This fact is clearly stated by a former senior member of the board of the Bundesbank, reflecting on the conditions of regulation that regulators need to grapple with.

Senior board member Bundesbank: if both us, we are a bank, then we work according to certain restrictions, one of the most important restrictions is that, relatively to competitors, we produce an acceptable result, so we will use the holes in regulation in an entirely legal way, this is not illegal, but instead completely incentive compatible behavior. This is why regulation needs to contemplate the second step, namely how do the regulated react (interview Frankfurt/Main 08/23/2010, translation M.T.).

Such loopholes allow a profitable misrepresentation of reality, which is still in line with the law. These loopholes become bigger, if the standards are bound to legal form, as the hands of the auditor are tied, whatever the economic facts on the ground, if legal requirements are fulfilled:

Senior standard setter IASB: “I remember when I was in 1995 consulted by people saying whether you would have to consolidate this in French GAAP and I said, well, as long as you don’t have any share in it, you don’t have to consolidate anything, you are free, which was of course horrible, I mean it was the law” (interview Paris, 01/21/2011).

If a structure avoids all the facts used to circumscribe a certain category in the law, there can hardly be any discussion between auditor and audited. This experience is reflected in the reflections on the state of affairs before SIC 12 was introduced in Germany by a senior auditing manager of a German auditing network, reflecting on the possibility of an economic substance analysis:

Senior auditing manager: “in form of lip services it (the economic substance approach, M.T.) existed, but I think we have it, always when it mattered so when the economic substance differed from the legal things, it was very difficult. If you have an auditor here, a client there and a group of lawyers next to him, then it is very difficult to clarify to them that what they do think is lawful in their legal way of viewing things, with their law texts at hand, what they think is lawful that it is not lawful because it is not reconcilable with the economic viewpoint, and what does the client say, of course? He says, I believe the lawyers and so he gets a legal opinion ... always when it became difficult in the questions of corporate conglomerate law, then the lawyers have produced these legal opinions and then it became very difficult against these legal opinions” (interview Berlin 05/03/2011, translation M.T.).

This quote vividly depicts the groups involved in the dialogues over the off-balance sheet status and the way in which auditors are weakened by a legal approach to auditing. Besides the representatives of the auditing and the audited company, there are legal advisors⁷⁶ at the table, seeking to influence the final decision by emphasizing that only clear criteria mentioned in the

⁷⁶ Often there are also regulatory advisors from other big auditing networks, which seek to influence the discussion. This fact was confirmed to me in an interview with a practising corporate lawyer (Cologne 11/06/2011).

law are to be applied for the decision. They have structured the relationship between the special purpose entity and the conglomerate in such a way to avoid all these clear cut criteria.

To inhibit any deviating opinions by the auditor, legal opinions are produced, which justify the position of the conglomerate, which would overcome most auditors' resistance, as the capacity of the auditor to issue dissenting opinions on certain accounting treatments is limited by the law⁷⁷ if the accounting issue is not clearly specified in accounting standards and an economic substance approach is not explicitly legitimized by the standards. In such a situation, if a conglomerate can present a defensible position for its accounting decision, the auditor has to accept the financial statement as prepared by the conglomerate, even if he qualifies it in the auditor's report as against his own personal interpretation. Once the consideration of the economic substance of the relationship is explicitly recognized, auditors have a tool to challenge those structuring.

A corporate lawyer reflecting on the negotiations between auditors and audited after a SIC 12 like rule was introduced in German law, confirms the position of the auditors as defending economic substance and becoming independent of legal opinions, which before the introduction of SIC 12 in Germany were ending the discussion.

Interviewer: so in the end the auditors are the defenders of economic substance?

Corporate lawyer: absolutely, and interestingly the possibility existed before the new law, you could have done economic substance over legal form already in §290 paragraph 3, that was never really used, but you could have if you wanted to. But now under the new law, definitively..., the legal finesses, they are not interested in, makes also sense, they are not lawyers, they don't rely on such opinions but instead they form their own opinion regarding economic substance over form. (interview Cologne, November 6th 2011, translation M.T.).

Before specific language was introduced in the German commercial code, there already were possibilities for pushing through an economic substance approach by the auditors, as the

⁷⁷ In countries like Germany by law, in §322 of the HGB. In anglo-saxon countries, these issues are regulated by the profession itself.

supreme court of finances had repeatedly issued interpretation of tax laws in line with the economic substance (interview auditing manager, Berlin, 05/03/2011). So why was this possibility not used, if auditors did feel unease about constructs by corporate lawyers? It was not implemented on the grounds that it was a rather specific interpretation, which contradicted much of the mainstream view even in auditing circles (interview German auditors' association 04/14/2011) and insisting on it meant straining the client relationship (senior auditing manager in Berlin, 05/03/2011). As auditors are dependent on a good relationship with their clients to cross-sell other services (s. Coffee 2006), such confrontation is not sought in moments when the legal situation is not clear.

One of the goals of the rewriting of the rules of the International Accounting Standard Council from 1996-1998 was to overcome this structural and legal incapacity of auditors to rein in the structuring attempts of corporate lawyers and legal advisors. It resulted in the most progressive standard to force SPEs on the balance sheet of conglomerates (SIC 12). SIC 12 is so progressive, as the auditor is asked to apply an economic substance approach to the relationship between SPE and sponsoring conglomerate. The genesis of this rule and its impact on the negotiating situation gives itself important insights into the nature of special purpose entities, which are constructed in direct response to the rules.

4.6 SIC 12 or how to regulate a product of regulation

Given the growth of SPEs and their growing abuse for off-balance sheet financing, accounting standard setters saw themselves forced to rewrite the rules. The standard interpretation SIC 12 of the International Accounting Standards Committee that was issued in 1998 was developed without much lobbying pressure by the banks and was explicitly aiming at

and capable of capturing SPEs on the balance sheets of banks (Larsson 2008). At that moment, the accounting standards of the International Accounting Standards Council were still of no particular importance to any of the large conglomerates around the globe as they used domestic GAAP or US GAAP as their accounting frameworks. This fact allowed the IASC to innovate with much less interference from the banking industry, as is reflected upon by a standard setter involved in the creation of SIC 12:

Standard setter: under the old structure there were advisory councils, they (the International Bankers Association, M.T.) did not have a representative on the interpretations committee, so I don't think this one went unnoticed, but I don't think we experienced the lobbying effort then that we probably would today if we were pushing it today, and that is part due to the success of IFRS, it is now being used, when we put out SIC 12 and the EC hadn't made its decision, it was very unclear who was actually using it" (interview London 02/22/2011)

And even in this situation, the comment letters of banks received by the IASC concerning SIC 12 were very negative and it was only the insistence of the IOSCO, the international body of securities supervisors to pass strong standards, which kept the IASC on course (Larsson 2008).

In the new standard, autopilot mechanisms were explicitly qualified as a means to exert control and the interpretation emphasized the analysis of economic substance over legal form in the relationship between the SPEs and the bank. The standard specified that, notwithstanding the lack of shares in the SPE, if a bank maintained the majority of risks and rewards stemming from that entity and/or exercised direct control over it, it had to consolidate it on its balance sheet. The rule was so potent that lobbyists from the European Securitization Forum complained that almost no off-balance sheet financing was possible under International Accounting Standards (IAS) and asked the International Accounting Standards Board (IASB) to repeal SIC 12 (s. European Securitization Forum 2002, s. also Jeffrey 2002 comparing SIC 12 unfavourably with US and UK rules which permit more off-balance sheet financing). Rather than giving clear rules

for the assessment of control, it provided the auditor with indicators and principles that he had to apply in actual practice. While this turned out to provide the auditors with a much greater power to negotiate with the auditees, it was a serendipitous discovery. The formulation of the rule SIC 12 was shaped in interaction with existing special purpose entities the standard setters would encounter in their practices as auditors, and analyzing these structures clarified that there could not be a simple fact pattern given to auditors for the detection of special purpose entities to be consolidated on the balance sheets of their parent. Providing indicators rather than clear rules was initially a response to the complexity and the singularity of all these different SPE constructions the standard setters encountered, when they considered revising the rules on the off-balance sheet status for special purpose entities. Those engaged in the exercise were struck by the complexity of the operations as well as the lack of a singular fact pattern.

Senior accounting standard setter IASB 2: “we said, look, some of us haven’t seen these things before, it is very complex, could you give us a fact pattern, and he brought us some material that related to a couple of transactions and we started with that material and what we discovered was that you could never describe the fact pattern in a way that most people would understand without spending a long time, and also we found that if you went down that path, that is how we started, let us go and describe a typical transaction, **and we have encountered two problems, the description is going to be horribly complicated and to describe it adequately, so either do a superficial description, such that it becomes meaningless, or so fact-specific that we feared it would have no general application.**” (interview London 02/22/2011, emphasis mine)

Formulating a rule based on the fact patterns seemed impractical for two reasons: first, there were so many different fact patterns that it was impossible to capture all of them in a single standard. Special purpose entities do not fulfil only one task or economic function, but instead are tailored by lawyers to the individual needs of banking conglomerates and their partners. Each new task requires a new set-up. The second reason resides in the reflexive nature between special purpose entities and the rules deciding if they are to be placed on the balance sheet of a

conglomerate. Given that SPEs are structured in interaction with accounting rules, providing such fact patterns to auditors would at the same time have provided those structuring SPEs with guidance on how to circumvent the new rule. This characteristic of the rule would have defeated the purpose of the rule itself, as the involved standard setter makes clear in the following remarks:

Senior standard setter IASB 2: “we initially said show us something that is happening in practice... and we were really struggling with this awful fact pattern, interviewer: because in fact there was no fact pattern?”

Senior standard setter IASB: no, there was no pattern, and then page after page, you needed diagrams to remember who was doing what and as I said we could have done it, but our concern was then it would sound so particular to that transaction that it’d be very easy for somebody else to construct one that doesn’t run into these fact patterns, and that caused a change of heart... maybe we come at this in the wrong way, why don’t we try, rather than dealing with the facts, let us go back to IAS 27 and see if we can develop indicators.” (interview London, 02/22/2011)

Indicators, rather than clear calculative guidance are used in SIC 12. In the standard, it is explicitly stated that the indicators should not be understood as a checklist, and that the judgement of the auditor has to consider all relevant factors, extending the review beyond these indicators alone (s. EC 2009).⁷⁸ To investigate the economic substance of the relationship between SPE and conglomerate, the standard provides four indicators to determine if a parent company was controlling an SPE. These regard the question if the SPE was acting on behalf of the parent, if the parent had decision making power (which explicitly included the autopilot mechanism), if the parent company is exposed to the majority of rewards or if the parent company is exposed to the majority of (residual) risks. (s. PwC 2004: 7). Auditors have to analyze the risks and rewards emanating from a special purpose entities towards the conglomerates it is dealing with. If a conglomerate is found to be exposed to the majority of risks

⁷⁸ In the new rule it reads “An SPE shall be consolidated when the **substance** of the relationship between an entity and SPEs indicates that the SPE is controlled by that entity” (EC 2009: 1, emphasis mine).

or rewards of the business of this SPE, then a strong case can be made that this SPE should be consolidated on the balance sheet of that conglomerate.

4.7 The new negotiating situation

Of the four indicators, the analysis of risks and rewards is a particularly potent countermeasure against the regulatory arbitrage that drives the installation of SPEs, as it attacks the profit motive underlying the structuring. To structure the relationships between the banking conglomerate and the SPE to evade the indicators of control comes at a certain cost, which needs to be justified by a certain gain. However, if the party that sets up an SPE also has to renounce the majority of rewards emanating from the SPE, this gain justifying the structuring activity vanishes. This fact made the analysis of the distributions of risk and rewards of an SPE become the most contentious issue in the negotiations between auditors and the audited.

The distribution of risks and rewards often was the final, determinative criteria in the actual application of SIC 12 (interview regulatory advisor Amsterdam, 10/06/2011). The following remarks from an accounting expert in the technical division of a large auditing network are very informative regarding the way SIC 12 is structuring the conversation⁷⁹:

„of course special purpose entities are an important topic, possibly one of the most important, but it is also one where you read the standards and ask yourself, ok, but what does this mean right now for the specific case, ... it is immanent to a system of standards which is principles based, and therefore creates general, I always say a framework for judgment, ..., it is better than nothing, it creates a framework for judgment, in which you can then judge facts or arguments. (interview Senior accounting manager, large auditing network, Duesseldorf, 02/21/2011, translation M.T.)

⁷⁹ Members of technical divisions are particularly valuable informants on this dialogue, as they become part of the conversation between the auditor and the audited regarding certain disputed accounting decisions, where they intervene as experts regarding the standards to make sure the balance sheets of the audited are in accordance with these rules.

This fact, that SIC 12 provides only a “framework for judgement” precludes the exploitation of clearly set out rules by those structuring the SPEs. It also precludes any prefabricated schemes according to which these decisions can be taken by the auditing team, instead requiring a singular case analysis. Asked about the amount of instructions the auditing network provides to its auditors regarding the analysis of SPEs in order to facilitate the application of the standard, the same auditing professional explains

“I don’t believe that we do have, and neither our competitors do have a replacement for that, the standard setter is not doing it, he only provides a frame and we have now our own checklist here, no, with certainty we don’t have that here. What we have with certainty is the attempt to concretize certain aspects which are not yet decided upon in the standard. But I am sure that we don’t have a grid that you have to apply to a certain case and at the end, you get at least for our auditing network in a normed fashion a result that will exculpate the auditing team, it is like that or like this. This is not it and I don’t think this is even possible. ... I cannot give you a list that says, we don’t have such a list, for that the cases are also simply much too different.”

The differences in the construction of different special purpose entities precluded simple rules and they are also the reason for the impossibility of a simple, standardized approach to the application of SIC 12. The lack of an objectifiable fact pattern leads to longer auditing stints and thus more costs for the audited, in order to be able to deal with each singular case.

The negotiating situation is made more complex by the fact that while SIC 12 requires an analysis of the majority of risks and rewards, it does not clearly specify which risks should be taken into account or how to weigh them but. As the following quote from an auditing expert in the technical division in another auditing network in the Netherlands shows, this created some problems.

Senior auditing manager: “I remember from my audit experience that I had many discussions as to the question if the SPE had to be consolidated or not, and that was the interpretation of the standard like you have all kinds of interpretation issues with IASB and SIC 12 as well... where you had to decide do you have the majority of risks or not and which risks do you take into account, is it liquidity risks or credit

risks, whatever, so there was absolutely latitude in interpretation of the rules because they are rather principles based and not very detailed

This negotiation in the grey area, “where you could say that on the one side you could argue that you control the SPE and on the other side you could argue that you do not” (senior accounting manager, Amsterdam 07/05/2011), takes place mostly over the distribution of risks and rewards. Such risk analysis is confronted with the evident problems of calculation: which events should be taken into account? How can they be detached from others? In which relation do these different risks stand towards each other? And how can one determine that the final result, regarding the judgment as to who carries the majority of risks and rewards was made in a way which satisfies professional standards? These questions are negotiated between the two sides according to the conventions developed by the auditing networks.

Senior auditing manager: Of course we do have certain conventions, in case of doubts I first have to focus on the risks, but what are risks, all of them? ... And the question what is risk, are these all things or do they only regard variable income flows, to which I am exposed. So negative and positive ones, there you of course try to create certain boundaries, until even we went to apply the calculations according to US GAAP, which are working with different expected values for different scenarios, and just to see what comes out at the end of the day in three different environments; who is bearing the risks in the end? Of course we are doing that too (interview Duesseldorf 02/21/2011, translation M.T.)

Rather than being totally arbitrary, certain conventions are established by the auditing networks and structure the conversation between auditors and audited. Even calculations according to US GAAP are applied. However, while these calculations guide decision making in US GAAP, these are only indicators for auditors under IFRS. They help the auditor to make a decision, however they don't pre-determine his position. One marked difference between the US system of brightlines and the IAS resides in the definition of the majority of risks. While in both systems the absolute majority of risks (rather than the relative) has become the decisive criterion,

in the US it has been defined as 50.01% of the risks. If the calculations of the auditing team for the three different scenarios led to the calculation of 49.99% or less, the SPE were to remain off-balance sheet.

In the principles based approach, such precision landings by the audited are made more difficult as each auditing team can make a case-based decision and is therefore operating in a wider space of discretion. In this respect a broad principles based approach is more appropriate to deal with the problem of regulatory arbitrage as it makes optimization for corporate lawyers and auditing advisors more difficult, given that it is now in the discretion of the auditing firm, which meanings certain words should take. For example, applying SIC 12 and paying attention to several indicators of control of an SPE, the presence of some can lead to a tightening of the requirements for the measurement of others, as a Dutch regulatory advisor confirms reflecting on the time after the introduction of SIC 12 in Dutch GAAP in 2003:

Regulatory advisor: there is always something about the economic benefits; because why don't you sell the mortgages to your competitors? You do that because you still want access to these people for commercial reasons; so that means that under SIC 12; with the four examples of control, you need to build in an extra slack there, so if you have an analysis that says that you have transferred 51% of your risks and rewards, sorry that is not good enough,

M: ahh, because it is a principles and not a rules based system; you cannot accept 51%, it has to be a little bit more

V: **and we know that there is autopilot involved, and we know that at a second point of activities, the activities of the Special purpose entity are to a certain extent conducted for the benefit of the originator.** So we have an informal rule that you should at least transfer 60% of your risk and rewards, otherwise don't even come to talk about off-balance sheet status. (interview Amsterdam 10/06/2011, emphasis mine)

It is the overall assessment of the transactions by the auditor, which is required by the standard that justifies to increase the requests by the auditor. Standing alone, the majority of risks or rewards is a simple 50%, but taking into account the fact that the other indicators of

control mentioned In the standard are present, such as the autopilot and the set-up of the SPE for the bank, the auditors are empowered to become more demanding in terms of the distribution of risks and rewards. This latitude in the area of interpretation imposes a very specific mode of operation in the production of the accounting decision. It is co-produced in a dialogic fashion between the auditor and the audited, regarding what is accepted and what isn't and how much needs to be restructured in order to avoid on-balance sheet status. In the following, the dynamics of these discussions and the conditions under which they occur will be presented. What will become evident is that off-balance sheet decisions are the outcome of lengthy heated debates and a negotiation process, in which the audited exert pressure to obtain the most beneficial interpretation possible.

4.8 „Stitching on the edge”

Bankers, lawyers and regulatory advisors of auditing networks spend much time and resources seeking ways to structure the deals in such a way as to achieve a desired accounting decision. This structuring work by bankers, lawyers and regulatory advisors is a back and forth with the auditors and other accounting professionals that act as regulatory advisors⁸⁰, in an interactive process which is shaping the final product. This becomes evident from the statements of the corporate lawyer below, asked about the role of lawyers in the structuring process:

Corporate lawyer: of course to make the contracts, I do need my lawyers and they do make these contracts in the end, but this is like in other areas such as taxes, where tax and corporate lawyers work together, so here the lawyers and the auditors work very closely together, the structures are developed, a draft is made and sent to the auditors and then you ask the accountants, if we were to do it like this, what would you say to the question of consolidation? And then they say, well I guess you would have to

⁸⁰ Since Enron, and the subsequent regulatory changes it brought, accounting advice is no longer allowed to be given by the firm which is auditing the balance sheet. For this reason, regulatory advisors which are accountants and have worked in the auditing departments of their auditing networks before are hired by the corporations which seek to structure their SPEs in order to ensure the desired results.

consolidate, but we don't want, so how can we avoid that? Then it is said, that you have to change the structure there and there in this way, this is a back and forth, the accounting professionals are involved very early on, and also often others than the auditors... the auditor is, let us say PwC, but the advisor comes from KPMG. ...the contracts are made by lawyers but this is checked before, what would be the balance sheet consequences, what the tax consequences,... everybody is giving his input, and often it is such that there are goal conflicts, that they say to avoid consolidation we need this clause, but then the corporate lawyers say, then we have a problem at another position. ... so you cannot say that the legal advisor is developing the structure and the accountants get it later on their table, that is coordinated beforehand (interview Cologne 11/06/2011, translation M.T.)

In the same vein, a bank manager of a German bank agreed that the process of determining the accounting decision for a potential product is undertaken in cooperation with the accounting advisors of the bank and through checking with the auditor (interview banking manager, responsible for development of new financial products, Frankfurt/Main 12.07.2011). A regulatory advisor confirmed the early involvement of their services in the process, defining his work as a form of quality control:

Interviewer: and if I may ask, at what point in the process are the regulatory services of your firm requested?

Regulatory advisor: usually already relatively early; because you need to get the accounting part streamlined, that means you do want a transfer off-the-balance sheet. ... so we were asked and in this sense we were relatively early involved, they would have chosen their portfolios and came to us with their term sheets or presentations, we cannot actively advice, legal advice is forbidden to us, but of course we can say according to accounting standards this doesn't work, and there at least this and that has to be guaranteed... for them it was a form of quality check (interview Frankfurt 06/14/2011, translation M.T.)

This interaction of accounting advisors, lawyers and the corporation leads to an initial construction of the contractual relationship of the special purpose entity with the banking conglomerate, seeking to make sure that off-balance sheet status is achieved while the bank remains exposed to the maximum amount of positive, upside risks. These structures, which seek to exploit all possible grey zones, are then presented to the auditors, where an intense negotiation

ensues. This leads to the “stitching on the edge” of these constructs, as a board member of a large auditing network in Germany, himself involved in the negotiations over these transactions called it.⁸¹

“And special purpose entities are a construct, which has been invented by lawyers to be able to do an optimization in the existing system of rules... but as I have always said in conversations, that goes until today actually, these special purpose entities are always, in exclamation marks **“stitched on the edge”, they are knitted in such a way that they fall out of the perimeter of consolidation**” (interview Berlin, 05/03/2011, translation M.T.)

The particular role he is ascribing to lawyers in the process in this quote and the following quotes need to be partially seen as an expression of professional self-defence.⁸² Whichever profession plays the leading role, “stitching on the edge” involves the negotiation between the lawyers of the audited and its regulatory advisors as well as the auditors, testing what needs to be done to end up on the desired side of the distinction. The remarks by a senior auditing manager from Amsterdam clarify the character of these negotiations, which take place in the grey zone where the decision of the auditor is not predetermined:

“and I can imagine that in that moment many entities did not want to consolidate these SPEs and that the auditor would agree with that. **That was after finding it acceptable with the rules as they were, as there is absolutely some sort of grey area where you could say that on the one side you could argue that you control the SPE and on the other side you could argue that you do not,** ... I have been an auditor in financial services for some years and I have noticed different practices ... and others **who would more look into the grey area and try to circumvent consolidation and if we would not accept it as an auditor they would try to change contracts a little bit or change their economic position a little bit in order not to consolidate the special purpose entity**” (interview Amsterdam 07/05/2011, emphasis mine)

⁸¹ In German: “auf Kante genaht”

⁸² I have encountered the same professional defence on the part of corporate lawyers, expressing serious doubt about the integrity of auditors working as regulatory advisors.

This quote above shows the negotiation between auditors and audited at the margins, where auditors could request a change of contracts to satisfy their requirements. This capacity of the auditor leads to discussions already before the structuring itself is taking place.

Senior Manager auditing network: “I have had several discussions regarding such structurations with investment banks, as there was a couple of banks, which had developed something of that kind with their in-house lawyers and external law practices, possibly that it were mainly the banks. But I had plenty of conversations with lawyers in banks

Interviewer: and what did they want to know?

Senior Manager: No, they wanted to see how do you have to structure it, so that it fits on the edge, so that it just didn’t need to be, or not yet needed to be consolidated, so, how much risk do we have to shed, so that we don’t have to, especially under SIC 12 (interview Berlin 05/03/2011, translation M.T.)

After banks have already spent money on regulatory advice from accountants, they might still encounter the resistance of their auditors, which leads to a new round of negotiations and fine tuning of contracts, such that the specific requirements of the auditor can be satisfied. Asked about the fact that IKB, the bank which failed during the crisis did not consolidate its SPEs in the balance sheet for the period that ended 2006⁸³, the same manager explained:

“no, because this SPE was knitted in a way that it didn’t have to be consolidated, there you can always debate, if it is stitched on the edge in that way, does it belong inside or does it not belong inside, and then you get the question, the the corporation comes and asks, now tell me how much more risk do I need to transfer to somebody else in order for you to accept it, so that I don’t have to consolidate it, and then you continue to reflect, and so you develop a model which is exactly on the edge (interview Berlin 05/03/2011, translation M.T.)

Stitching the SPE on the edge, to stay exactly outside of the balance sheet is an iterative process. In particular the transfer of risks and rewards to satisfy auditor demands is a stepwise

⁸³ IKB had to be saved by its mother, the German bank for reconstruction (KfW), after its SPE „Rhineland Funding“ caused such severe liquidity problems by drawing on the entire liquidity facility IKB had offered it. The new auditor of IKB, PwC, which came in after the crash, issued a new statement in fall 2007, stating that after new calculations, it found that its predecessor, KPMG had made a mistake and that “Rhineland Funding” should have been consolidated before the crisis. However, such bickering might simply represent the exploitation of an opportunity to shame a competitor.

process, in which the audited seeks to hold on to as many risk and rewards as possible. This process is driven by the consultants, as the manager elaborates

“it is so to speak like that, you have consultants behind, which say, listen we will structure this for you, now we talk with the auditor and the first reaction is, it has to be consolidated. And then they say, if we change it in this and this way, do we still need to consolidate, and so you are asked again. Then the auditor says ok or says has to be consolidated, then they continue working, and then you work out the different triggers, and then you say ok, now we take away this risk, then you have to accept it, and then at some point in a process of negotiation you have taken away so many risks that you can say, now the majority of risks and rewards is no longer with the XXX-bank (interview Berlin 05/03/2011, translation M.T.)

A banker, involved in securitization confirmed this iterative procedure regarding the distribution of risks and rewards.

Interviewer: because then the auditors became more strict and there comes the client and says I would like to have off-balance sheet status and then it starts

banker: the negotiations, the haggling, yes a little bit it was like that

Interviewer: that is then stitched on the edge, so that the majority of chances and risks is not with you

banker: exactly, yes, exactly (interview Frankfurt/Main 06/14/2011, translation M.T.)

That the banker was enthusiastically confirming the expression “stitching on the edge”, a metaphor which is usually not applied to these operations, confirms the metaphor as an appropriate description of the process. Such “haggling” over the distribution of risks and rewards ends with a change of the contracts which fulfils auditors’ demands. An auditor, speaking of her recent experience involving the large scale desire for derecognition of assets of one of its clients confirms the changing of contracts as the way to appease the auditor:

Auditor: “I think it is also relevant, if you look at getting things off-balance sheet especially for financial institutions, I had one client with a big IAS 39 derecognition, in the end they did derecognize, **well, they changed the contracts and then they did**” (Interview Netherlands AMF, 10/07/2011)

Such changing of contracts, shifting the risks to other financial actors is not only costly due to the production costs of contracts per say, but it also requires the payment to these other actors in order to accept to shoulder these new risks (interview senior management auditing network, Berlin 05/03/2011). This means that all requests of the auditor impinge on the bottom line of the client that is seeking to generate a profit from these off-balance sheet activities. These requests can in the end even destroy the profitability of the entire product. Accordingly, dialogues between auditors and audited to often become heated and aggressive. These aggressions are further nurtured by the fact that the audited seek to exploit the space of discretion of the auditor in their favour.

4.9 Violence in the negotiations and its impact on the quality of the standard

The abrasive style of these dialogues remains hidden to outsiders, as the final result of these negotiations most often is the approving signature of the auditor, once the changes he has asked for have taken place or a certain compromise is found. But to insiders, they are common occurrences. A corporate lawyer, working in the field of securitization confirms the heated nature of the exchanges between auditors, audited and their advisors in the structuring process.

Corporate lawyer: “I have to do with them all the times, that the auditors argue fiercely over accounting questions in the meetings with the corporations and their other advisors, that is on the daily agenda

Interviewer: but you don’t see that from outside, as it is all approved in the final financial statement

Corporate lawyer: yes yes, of course, at the end you get a consensual result (interview Cologne, 11/06/2011, translation M.T.)

Some of these confrontations are of such a violent nature, that certain auditors have sought to quit securitization, as the story shared by an experienced auditor in the technical division of an auditing network in Paris exemplifies.

Senior Auditing Partner: I had a young woman working with me, she was HEC⁸⁴, she became partner at the auditing network with 32, so a brilliant girl, she was always given the best grades in her evaluation, she had no clients, it was technical division, an excellent woman and so she told me that she doesn't want to do securitization anymore, what was that supposed to mean? The meetings with the bankers, the lawyers, the clients and the accountants, they were violent, so you reached a level of violence, she said it, a level of stress so that she said she doesn't want to do it anymore. Violence, she is still doing it, she has a team and everything, but that shows the paroxysme at which we arrived (interview Paris, 03/22/2011, translation M.T.).

The young auditor, mentioned in the quote, was working in the technical department which has the task to review all accounting issues which are disputed between auditors and clients and cannot be resolved between the auditors and the audited themselves. In this sense, the young auditor was working in the organizational unit where the fight between auditors and audited in the securitization business reaches its apex.

In these moments of tough negotiations, the audited are employing time pressure as a particular weapon to structure the negotiating situation to their advantage and gain some leniency in the application of the standards.

Senior auditing partner: "We asked our clients not to give us the books on the last evening, but that also happened, ... one day I say to somebody that it is not possible that they give us the deals always in the last days and one day, it is an advocate of Arthur Andersen and he says, ... but it is evident that one gives you the deals in the last moments, they give them to you on Friday and they will tell you they want to launch it by Monday... of course they give it to you the last day, if possible Friday to put you the knife to the throat, and like that you gain a capacity to negotiate, which is what happened, you have been forced to compromise on certain points, and once you accommodate, **they know very well when you have accommodated one client, that circulates in all the place of Paris which knows it, and the place is not big, so you have to accommodate all of them**, this I think is an environment, and they put up a pressure, incredible" (interview Paris 03/22/2011, translation M.T.)

Time pressure exerted upon auditors can over time lead to a relaxing of the standard itself, as an auditing network can impossibly grant specific interpretations of certain standards to one but not other clients. A banker in Germany confirms this spreading of rumours regarding the

⁸⁴ Haute Ecole de Commerce, the best business school in France.

recent trends as to which structures were permitted and which didn't. In order to gain this knowledge, banks invited the regulatory advisors of the large auditing networks into their office, asking them which were the most recent developments concerning SPE structures (interview Frankfurt/Main, 06/14/2012).

Through time pressure, violent confrontations and legal opinions, the audited are seeking to push through favourable interpretation of the rules and thereby conventions which facilitate off-balance sheet financing. Once achieved, these prior decisions will be reiteratively used as an argumentative weapon in future decisions. Auditors, in the end, are dependent on their clients, and while they can engage in fierce arguments, they need to seek pacified client relationships. This structural dependence on their clients in a recurring relationship has its peculiar effects on the decision making, as can be seen in the following quote that refers to the termination of such arguments.

Corporate lawyer: yes yes, in the end this is all a consensual, once in Germany in the old §324 of the commercial code, there was a certain procedure envisioned to clarify differences in point of views between auditors and the audited in a special branch of courts. This law, there was not a single case, it never became practical. Why? Because these disputes, of course they do happen, I know they are partially even very fierce and poor, but these are only driven to a certain point and then you gain an agreement according to the principle once you, once me (interview Cologne 11/06/2011, translation M.T.)

These processes of consensus formation will lead over time to a relaxation of the interpretation of the rules. The malleability of the interpretation of the rules in favour of the audited is a disadvantage of principles based standards, stemming from the fact that certain issues are not clearly specified in the principles-based standard. For example how and when the distribution of risk and rewards should be assessed, at the moment when the SPE is set-up, every

year or if there has been a material change in condition? Again, legal opinions by regulatory advisors seek to limit the possibility of consolidation for the sponsors.

Corporate lawyer: in SIC 12, it is only written, majority of chances and risks, this is the decisive criterion, there it starts already, what is the majority? ... if you took the stance, what certainly could be well defended, it has to be the absolute majority, and that you can risk weight your different scenarios, then a change in factual circumstances could change the risk weights for the different scenarios, and then my criteria for consolidation could change, which is why I always thought regarding this question that you do have to observe these structures all of the time

interviewer: but this is not clarified

lawyer: exactly, there are some legal opinion, which say explicitly that it only has to be checked if legal changes are undertaken, this is their position, but especially under an economic substance point of view it makes no sense, that you only accept the legal question as a parameter (interview Cologne 11/06/2011, translation M.T.)

On the margins of the standard, interested voices using legal opinions seek to impose practices in the interpretation of the standard that emphasize legal form and limit a view that favours economic substance. Pressures exerted on the auditors can lead to a consensus between auditors and audited on how the standard is to be interpreted as well as how it should be applied, which can severely weaken the capacity of the standard to force constructs on the balance sheet. The question then arises if principles based standards are weakened the longer they are in use and if they need to be revised to counter these corrosive tendencies or if there are other mechanisms for fixing problems with this form of standards.

4. 10 A rule to end all circumvention?

From the discussion above, the advantages of principles based standards which favour an economic substance approach in the realm of consolidation have become obvious. They at least permit a discussion where before none had been possible. At the same time, the violence and pressures exerted on the margins in the conversations between auditors and audited suggest that

also this form cannot resolve the problem of regulatory arbitrage once and for all, as the violence will extend the realm of the permitted over time.

Instead, there seems to be a cycle that characterizes off-balance sheet financing, best described by an experienced auditor, when commenting on the increasing use of SPEs in the 1990s:

Auditor and accounting professor: it is not a new thing. It is just that the rules change over time. So the companies want to find a way to keep financing off-balance sheet. So the banks find vehicles, the world becomes aware of that. The auditors tell the standards setters that they are not happy about this and the standards setters issues a rule about this saying you cant do that or if you do that, this happens. So then they go away and start the game again, so alright, if we cant do that anymore, let us find a new way of doing it, so it is an ongoing thing. ... **because they test the rules to destruction, they destroy the rules and the rules have to be remade.** (interview Paris 03/03/2011)

Testing the rules to destruction implies in the case of principles based standards the imposition of a beneficial interpretation of the principles which allow much off-balance sheet activity where little was intended by the standard setters. This work of erosion occurs at the margins, exploiting the ambiguities of the rule. It also operates with simple time pressure and intimidation. An interpretation issued for one client under these circumstances then has to be applied to all others. The standard setter who was involved in the creation of SIC12 acknowledges this impossibility to issue an ultimate rule limiting off-balance sheet activity, while defending principles based standards as the second best option. When asked about the possibility of ending irregular off-balance sheet activities, he answered:

Standard setter: “when you issue a pronouncement, people will look at it, and they will revise their strategies, if the economic incentives are still present they will do their utmost to achieve the most attractive result under those new rules, **so to some extent you moved the point along the spectrum, so you might say yes, we will get more consolidation, than previously,** you might discover that you have an awful lot of people spending an awful lot of time and awful lot of money to stay on one side of the line or the other and I think that is inevitable, ...and if you go to principles that is terrific **but you still are going to have a judgement and a grey zone, so neither is the perfect solution,** it is more of a question of ... which is the better route to go, would you rather have someone saying I am told that as long as this calculation works

out to be less than 3 or 4 percent, I am ok or would you rather have someone say do you think you are exposed to the majority of risks and rewards” (interview 02/22/2011, London, emphasis mine)

In this quote, the standard setter acknowledges the power of those seeking to structure their deals such that they “stay on one side of the line”, a force which you cannot control, given that you “still are going to have a judgment and a grey zone” in which those structuring will place their deals. A corporate lawyer, thinking about SIC 12 and even the new standard, IFRS 10 which comes into force in 2013 is also sceptical about the possibility to limit such activity once and for all:

Corporate lawyer: is this the wisdoms’ last conclusion? The IFRS 10, he is new right now, where even that one is not the wisdoms last conclusion, so I am just afraid that the problematic of special purpose entities is very difficult to get a grasp on, independent of the rule element you use” (interview Cologne, 11/06/2011, translation M.T.)

Why is an ultimate rule ending unruly off-balance sheet activity impossible? Because the structures of SPEs are determined in response to the rules which are seeking to capture them on the balance sheet. If you have principles based standards, the conglomerates will use the leverage over their auditors and push the interpretation of these rules in their favour. The dynamic relationship between SPEs and their rules means that one can only temporarily force SPEs on the balance sheet, until those structuring have found a new escape. Still, principles based standards might be the best way for dealing with the problem, as is clarified by a senior auditor in a technical department of an auditing network in Germany:

Senior auditor, technical department; no, the problem is not solved, there you are totally right, but as far as I am concerned, the circle, at least right now, I mean this is a process, this is as far solved as the market, as they are building their models, as far as you can say something standardized about it, we cannot write a handbook called treatment of SPEs where we then present the 1500 different models and then you look there for everything..., but because we don’t want something like that ... we make a

broad standard and that one leaves space for discretion” (interview Duesseldorf, 02/21/2011, translation M.T.)

While even an economic substance approach cannot end regulatory arbitrage, it does allow the auditor to become a decisive intervening variable in this “game”, rather than a bystander. Its opposite, the capturing of all SPEs by demarcating each single model (“1500 different models”) is economically not feasible and it would impose an enormous burden on the auditor when deciding over the balance sheet status of an SPE. Furthermore, such an approach would put the auditor persistently behind the curve (as you can only represent something which already exists) and would only further increase the motivation to generate new structures. In contrast, an approach like the one of SIC 12, which is indeterminate and principles based, reduces structuring activity as it becomes more uncertain if it will achieve its goal. In this respect, it is the appropriate response to the “Heisenberg indeterminacy principle” operating in financial accounting (Borio and Tsatsaronis 2005), in which the measurement of activity changes the activity itself.

However this does not mean that it is eliminating the problem. A principles based standard can only make the problem of regulatory arbitrage disappear on one level (the simple interaction between those structuring for regulatory arbitrage and the rules), but it will reappear at another level (the more complex negotiation between the auditor and the audited regarding what is allowed). It offers a more malleable, flexible approach to the problem, by forcing those who structure to interact with professional judgment and reflection instead of a checklist, but it cannot finally resolve it. The pressures upon auditors (time and money-wise) to cooperate with their clients will likely over time relax the demarcation of the size of conglomerates, allowing more leeway for balance sheet manipulation. A standard setter at the IASB, reflecting on this

difficulty to limit off-balance sheet financing pointed out:

“And you know if you have committed to something and if you can legally avoid to show it, as a liability or whatever, you will try to do it. So that if you leave the door, just a jar open and that is all, to people being able to do that, you will have a lot of off-balance sheet everywhere. **The recipe is not to give figures, percentages, the recipe is to give sound principles which people feel obliged to apply. Very difficult.**“ (interview Paris, 01/21/2011, emphasis mine)

The difficult aspect of such principle based standards is to instil in the auditors a strict interpretation of the principle and to generate the obligation to apply it, instead of opening up ways for their auditees to circumvent them. I will investigate how this can be done and role of state agencies in the process in chapter 5.

4.11 Discussion of Findings and Conclusions

Financial accounting numbers are the basis for much of the claims a society levels upon corporations. Conglomerates, the predominant corporate form active in financial markets seek to exploit the spaces of interpretation involved in generating their representation in accounting to minimize these claims. They do so by employing an army of advisors, to reshape the representation of their organization. These use the fact that general rules are by necessity over- or under-inclusive regarding the concrete cases to structure the business of corporations such that, on important matters of accounting policy, they end up in a grey zone unspecified by the rules. In the case of the off-balance sheet decisions for banking conglomerates, these structure the contracts to keep as much of the rewards of assets they transfer out of the balance sheet as possible, thereby shortening their balance sheets. In this way, they build up risks and rewards which are no longer represented on the balance sheet as assets. This means that recorded risks, for which the society does demand (costly) acts of precaution, and actual risks diverge, with

actual risks outgrowing recorded risks. As a consequence of this unrecorded risk-taking, profits of these corporations are growing, putting their competitors under pressure. It is in this way that such acts become systemic, and do not remain acts of single deviant actors as all corporate actors are compared according to the same measures generated by the same standards. This fact leads to a system-wide increase of risks which are not recorded on the balance sheet. The structuring of special purpose entities is just one expression of this persistent struggle to beautify balance sheets.

Principles based standards emphasizing economic substance over legal form seek to infringe upon the capacity of conglomerates to manipulate their representations in society. While they cannot prevent the beneficial structuring of business relations, they refuse the provision of clear guide-lines for such structuring activities. In this respect, they do impose a risk on those structuring their business activities in order to gain a beneficial accounting treatment. During their dialogue with their auditor, they might be forced to restructure to such a degree that the final outcome will no longer be worth the costs and the envisioned financial product will not be realized. Such risks might already deter all those marginal actors, for which balance sheet beautification has a value, but which becomes too small to pursue given the increased risk of failure. Keeping it a hot situation, in which the procedures for analyzing the situation are not completely predetermined, but instead can be changed by the auditor according to his professional judgement empowers the auditor to keep regulatory arbitrage in check.

The rules for the construction of balance sheets are more than just machines for recording business transactions. As already Weber (2002 [1905]) recognized, they are organizing business actions and impose their rationality on business men. At the same time, these rules do impose

their rationality on reflective agents, rather than dopes. This leads, in due course to attempts of these economic actors to manipulate the application of these rules to their advantage.

Off-balance sheet financing and its usage by banking conglomerates and other corporate actors to manipulate balance sheets is one such attempt. It cannot be totally eradicated, just as the distinction between on- and off-balance sheet and balance sheets per say cannot be eradicated. On the other hand, such misrepresentations seriously threaten the capacity of state organs and other stakeholders to regulate the behaviour of corporations. It is the task of accounting regulators to identify the developments of such constructs and to act against them. In order to do so, they need to be in close contact with the professional community of accountants. They can then react to a perceived exploitation of existing accounting rules by changing the rules or limiting these spaces of interpretation by issuing certain interpretations of the rules.

However, in how far they can and will do so depends on their capacity to force corporations to adhere to their rules, if their interpretations/ standards are legally binding and which instruments for enforcement they have available. It also depends on the capacity of conglomerates to veto such interventions. The policy networks engaged in producing these standards and supervising their application take different forms in different national political economies, which have an impact on their capacity to limit these spaces for interpretation for conglomerates. The following two chapters will detail the different temporal trajectories and content specifications by the way of which the principles of SIC 12 for the off-balance sheet status of securitization-SPEs of banks were introduced in the Netherlands, France, Spain and Germany. Conglomerates in these countries sought to influence the interpretation of identified accounting problems and thereby to drive the pace and direction of accounting reform. How well they can do so depends on their linkages to the different forces engaged in the rule setting. The

comparative analysis will show that the position of the banking regulator in the accounting regulatory regime made a big difference for the timing of the introduction of these new rules as well as their interpretation by the auditing networks. This position depended on the formal and informal links they entertained with the auditing industry, which permitted the free exchange of views, it depended on the expertise of the banking regulator with respect to accounting issues as well as its legal rights to interfere with the accounting decisions of auditors and audited alike.

Chapter 5: FORCING SPEs OUT OF THE SHADOW: THE STRUGGLE FOR THE CONVERGENCE OF DOMESTIC RULES TO SIC 12

“I find it central to realize that the most rules are not written by those who like the philosopher kings of Plato want to influence the salvation of the world, but that these are most often very influenced by those that are to be regulated in the end

interviewer: this is very critical

official: yes, but it is unfortunately like that, this is descriptive, not critical” (interview with former board member of the Bundesbank, in Frankfurt/Main, 08/23/2010)

5.1 Introduction

As I explained in the last chapter, conglomerates are constituted by performative acts of accounting, and their actions are structured by these rules. This chapter will address the decisive role that the conglomerates played regarding the evolution of the rules which constitute them. In my specific case these are the rules which determine which company has to be deemed a subsidiary of a conglomerate. The market for Asset-Backed Commercial Paper depended for its growth on the off-balance sheet status of the conduits that issued these papers. If the sponsoring banking conglomerates could not achieve this status, at least for the purposes of regulatory capital requirements, an important incentive for this activity would have vanished. As a consequence, when accounting standard setters set out to renew the rules on off-balance sheet financing in order to stem the abuse they had noticed, they encountered resistance by those conglomerates benefiting from lax off-balance sheet financing rule⁸⁵. A former member of the International and the French Accounting Standard Board elaborates:

„you know when you are engaged in a big project, which is going to change the way things are accounted for ..., the very first time you mention you are going to change it, you got lobbyists structured to counter whatever you are going to try, you have

⁸⁵ Banking conglomerates were not the only private actors which were pushing for lax off-balance sheet rules.. Conglomerates providing leases, another off-balance sheet-financing technique using SPE's and the conglomerates using off-balance sheet forms of financing were another force of opposition against new accounting rules.

people starting to scream already you are going to kill my industry“ (interview Paris, 01/21/2011)

The off-balance sheet status of ABCP conduits was threatened by the SIC 12 of the International Accounting Standards, which was the first standard to be able to recognize ABCP conduits as subsidiaries of banking conglomerates and thus to force them on the balance sheets of their sponsors. This transnational rule did not have any direct impact on European banks until 2005⁸⁶. However, in the period from 1998 to 2005, a period in which the ABCP market grew strongly and in which it became clear that the IAS were to be the European accounting standards, the question arose if SIC 12 should be emulated in national GAAPs in the meantime and if the information thus generated should be used for the calculation of core capital requirements.

The opposition to this convergence was voiced in nationally specific policy networks, which constrained or enabled the power of conglomerates to influence the process. I argue that the outcome of this argument over the governance of the ABCP-market, was shaped by how national policy networks were transformed in a reaction to the transnational challenge of the internationalization of accounting standards. The quest for comparable financial statements for all conglomerates in all countries and all segments of the economy, which is inherent to a common international accounting standards regime threatened the legitimacy of nationally idiosyncratic accounting regimes, which were often different for different sectors of the economy. The goal of transparency and comparability, favoured by international accounting standard setters and investors also threatened the legitimacy of national stakeholders in accounting regimes, such as banking regulators, in the formulation of accounting standards. In this chapter, I trace the transformation of the domestic policy networks in response to this transnational challenge to the policy networks involved in making new standards and how it

⁸⁶ And due to an idiosyncratic coupling of national accounting rules and banking law only a very limited impact for German banks up until 2009.

impacted the response to the transnational challenge on the rule level, the convergence of accounting rules for special purpose entities to the international standards.⁸⁷ If banking regulators were excluded from the standard setting or never included due to transnational pressures, an important force pushing for the convergence of domestic standards with SIC 12 was missing. If banking regulators asserted their role in light of these pressures, SIC 12 like rules were introduced and used by the banking regulators.

In this process, prior policy decisions in the process of harmonization of European Accounting frameworks and changes to the way accounting rules were set domestically had a decisive impact on the regulatory treatment of ABCP-conduits. Both of these developments were the outcome of how the tension between the national and the transnational level of accounting standard setting was negotiated domestically. This tension stemmed from the fact that each level maintains autonomy in decision making at a particular territorial scale, holding level-specific understandings of a particular collective good (s. Enderlein et al 2010: 2f), while at the same time the European level increasingly encroached upon the national one. In the following I will shortly discuss the most important insights which can be gained from the literature on transnational governance and its impact on national governance arrangements. I will then use these insights to analyze the interactions of these two levels in accounting and how they transformed the interaction of private and state actors in rule making activity domestically in my four cases.

5.2 Governance in the accounting sector- from national to multilevel

⁸⁷ The reader should note, that as indicated in the method chapter, the case of Spain is built only on secondary data, whereas the cases of Germany, France and the Netherlands are based on the 64 semi-structured interviews undertaken for this study.

Given how distant the state is for the actual practice of accounting, and that he is only one, even if a very important actor in the generation and legitimation of new accounting rules, it is most appropriate to analyze the development of accounting rules and practices in terms of governance. Governance in a sector, as opposed to simple hierarchical government by the state implies that private actors are involved in decision making in order to provide common goods” (Heritier 2002:3). They are becoming partners in government, “sharing in the state’s authority to make and enforce binding decisions” (Streeck/Schmitter 1985: 20). Research on governance inquires into the difference **governance architectures** (organizational arrangements which link private actors, their competencies and interests with state agencies⁸⁸) and the **instruments** used in regulation have on policy outcomes (Mayntz 2009: 80f)

National governance architectures and the choice of policy instruments have increasingly come under the influence of transnational governance agreements⁸⁹ emerging in parallel to, or taking over substantial parts from national regulation (s. e.g. Schuppert 2006). Scholars investigating this trend have pointed out that the most recent period of globalization, accelerating from 1980s onwards) is distinct in this “increasing formalization, structuration, codification, standardization and depersonalization of the rules of the game in the transnational space” (s. Djelic and Quack 2003:4f). They have inquired into the impact of this transnational governance formation on national governance structures (ibid, s. also Djelic and Quack 2008), conceptualizing it as a double process of institution building on the transnational level and

⁸⁸ Policy networks have been the central concept to analyze the architecture of state-private interaction. On an ontological level, they carry a “translator function” (s. Schneider and Werle (1991: 133), translating technical problems into economic problems, which then become translated into political problems. On an epistemological level, policy networks provide sensitivity to actor constellations and influence positions in attempts at translation and coordination (s. Jansen 1991: p. 141).

⁸⁹ The term transnational refers to the fact that while these governance mechanisms are operating across several national boundaries, they are not set by an international body, where nation states negotiate (such as the United Nations), but instead are set by bodies which are not dominated by nation states. Transnational as a term is also more bounded than globalization, pointing to the fact that many “global” phenomena in fact only hold for a certain group of countries, and not all.

institutional transformation on the national level (s. Djelic and Quack 2003: 7). This conceptualization gives us a decisive advantage on how to understand the impact of globalization on national political economies.

The comparative political economy literature which investigates the impact of globalization on banking regulation has pointed to the role of national institutions as “filters of globalization” (Busch 2009: 227), emphasizing the role of domestic interest groups and institutional structures of authority in how polities adapt their policies in the light of transnational pressures and agreements. The transnational governance literature allows us to make the next step and to ask if and how developments in the realm of transnational governance are changing the configuration of national institutions? While these levels are independent, the transnational level is exerting isomorphic pressures upon the national one, bringing about changes in the architecture of governance and policy instruments. These institutional changes at the domestic level partially reinvent national institutions in a process of de-institutionalization and re-institutionalization (s. Djelic and Quack 2003). Institutions on the national level of governance, understood as “standardized interaction sequences” (Jepperson 1991: 145, quoted in Djelic and Quack 2003) are challenged by newly emerging standardized interaction sequences on the transnational level. In the process of adaptation, old sequences are de-institutionalized and new processes and new players included in the new national governance architecture. This relationship is not merely receptive. Instead, the national level is seeking to restructure its architecture and its use of policy instruments in order to influence the ongoing evolution of transnational governance formation itself, seeking to upload their input (s. Bueth and Mattli 2011). In contrast to Bueth and Mattli, who emphasize path dependency and slow adaptability

of the national level to the IASC in terms of institutional complementarity (ibid: 13⁹⁰), I find instead that national governance structures in accounting in Europe were often changed to a remarkable degree in order to increase the influence on the transnational level. National governance architectures were transformed to reach more legitimacy on the transnational level in order to increase the capacity to influence policy outcomes there. This was one major motivation for isomorphic pressures exerted upon the national level.

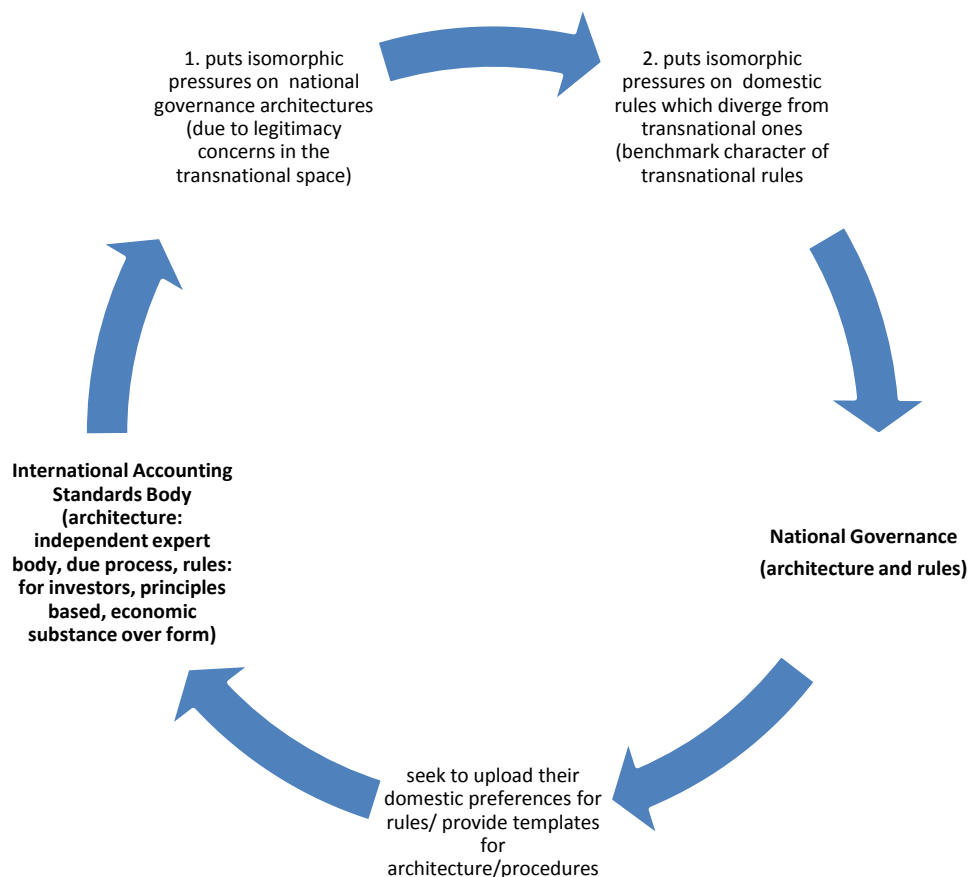


Figure 18 Interconnectedness of different levels in the accounting standardization

⁹⁰ Institutional complementarity refers to institutional similarities between the national and the transnational level. If these are close to each other in terms of decision making structures, national standard setters can have a greater influence on the transnational one according to Buehne and Mattli (2011). However, they assume institutional complementarity as a given, as “the foundations of most domestic institutional structures of standardization were laid many decades ago and have changed little over time.” (ibid: 13).

With respect to isomorphic pressures emerging from the transnational level, one has to differentiate between isomorphism of governance architectures or structures vs. isomorphic pressure on the content of rules inherent in a specific governance regime. In the case of accounting, pressures on the architecture focused on the question of the involvement of the state in the process and the style of standards formulation, with a transparent due process of comment letters vs. a collegial style, in which standards are decided in a consensual way. In the case of accounting instruments, the question surrounded the character of the rules. Should they be principles based or rules based, should they favour economic substance or legal form? Isomorphic pressures in the field of accounting standards setting on these two different levels were mimetic, coercive and normative (DiMaggio and Powell 1983)⁹¹. They were mimetic because there was large uncertainty over the future of standard setting in Europe, which caused convergence upon the models seen as most legitimate. It was coercive, because of the role the EU played in seeking harmonization of accounting standards, but more importantly because of cost pressures and national competitiveness concerns, which set an incentives for convergence of national with transnational accounting standards (s. Biener 2000). There were also normative pressures for the convergence from the profession of auditors, in particular from the big auditing networks (for the French case, s. Ramirez 2010). Bringing about convergence of domestic with transnational GAAP benefited these networks, as their experiences with transnational accounting standards favoured them over national competitors. These isomorphic pressures from the transnational space were challenging the domestic distributions of power which had crystallized in governance instruments and architectures. The transformation of the structure of domestic

⁹¹ These authors define mimetic isomorphic pressures as those emerging when uncertainty over future development in an organizational field prevails. Normative isomorphic pressure is defined as emerging from professional groups inside of an organizational field according to the norms and values they prescribe to. Coercive pressures refer mostly to state agencies which force isomorphic change on an organizational field.

governance architecture and of accounting rules for financial statements which emanated from these isomorphic pressures were decisive antecedents for the regulatory treatment SPE's. In order to understand the latter, we need to appreciate the emergence of the transnational challenge to domestic accounting standards for consolidated financial statements, which started in the 70s and intensified in the late 90s.

5.3 The quest for the harmonization of accounting standards in Europe

Before the 1970s, accounting standards for consolidated financial statements had remained largely underdeveloped in many European countries compared with their anglo-saxon peers, due to the underdevelopment of capital markets and the much later stage at which conglomerates as a form of business organization reached predominance in continental Europe.⁹² For these reasons, up until the 1980s consolidated financial statements led a shadowy existence, if they were produced at all. Often they were not much more than a small appendix to the individual financial statements of the parent company (interview German standard setter, 05/03/2011). The step-wise privatization of state conglomerates and the growing role of capital markets to finance investments, rather than banking conglomerates created the need for more sophisticated techniques of accounting for this organizational form.

The European Community played an important role in modernizing accounting rules in the 70s and 80s with the 4th directive on accounting in 1978 and the 7th directive in 1983 for consolidated financial statements. The 1983 7th Directive on Accounting made group reporting

⁹² Conglomerates were first allowed to form in 1890, when companies were granted the right to hold shares in other companies and thereby to control them (s. Perrow 2002). They became the dominant form of business enterprise in the US in the ensuing merger wave from 1890-1910 (s. Strasser and Blumberg 2011: 8, Fligstein 1990, Roy 1997), forcing auditors there to develop techniques to deal with this new economic reality. They merged the different companies judged to be controlled by one parent company into one consolidated balance sheet, seeking in this way to provide financial market participants a "true and fair view" of the business activities and risk exposures of the conglomerate (Walton 2008). While these techniques were transferred to the UK, where they became common practice by the 1930s (ibid), they diffused into continental Europe at a much later moment and a slower pace.

compulsory for all groups above midsize, whereas previously “consolidation was rare in Spain, Portugal and Greece, it was not compulsory in most other countries” (Nobes 1996: 201) in the European Union⁹³. Given that European Community Directives were constructed in international negotiations between the members, they were filled with options allowing member states to block convergence and maintain national leeway if seen as in the national interests. Therefore, while achieving some convergence (s. Nobes 1996), much of the national peculiarities in the accounting frameworks were maintained. Rules for consolidated financial statements were no different and the choice of countries on these issues would predetermine if a rule like SIC 12 was easily compatible with the domestic accounting framework.

One of the strongest disagreements in the 7th directive on consolidated financial statements pertained to the definition of a group (s. Radebaugh and Gray 2002: 141f). The UK approach to consolidation based on share ownership and/or legal rights to control contrasted with the German approach, based on effective management control as well as share ownership criteria. This was resolved by a compromise, “whereby control criteria rather than ownership could be applied by member countries on an optional basis” (ibid), an option stated in §1.c of the Directive. The option states that “a member state need not prescribe that a parent undertaking must be a shareholder in or member of its subsidiary undertaking”⁹⁴. Countries could thus choose an option which would allow them to force subsidiaries which were deemed to be controlled by the parent company onto their balance sheets, even if these two entities did not entertain a capital link. Their choice in this matter would have important ramifications for the accounting treatment of ABCP-conduits.

⁹³ In Germany, partial consolidation was required since 1965, and in France, consolidation was becoming more and more the norm since the early 1970s (ibid). However, they mostly added to the individual accounts as an appendix.

⁹⁴ s. Seventh Directive: consolidated accounts of companies with limited liability, EEC 83/349: 4, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1983:193:0001:0017:EN:PDF>

The last effort to achieve harmonization in the accounting frameworks via directives before the 2000s was the Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions. It sought to establish convergence between the accounting for banking conglomerates and conglomerates in general. In this directive, one of the goals was to eliminate hidden loss reserves for banking conglomerates⁹⁵, a project which failed due to German resistance (s. Bornemann, Kick, Memmel and Pfingsten 2010: 4). Hidden loss reserves imply that the exact amount of the loan loss provisions a bank holds are not disclosed to the public in order to conceal the capacity of the bank and the banking system as a whole to absorb losses. This information asymmetry serves to calm markets and to prevent bank runs, while providing the central banker the informational advantage to know when and how to intervene. It was a measure of prudence inserted into accounting standards. Maintaining hidden loss reserves for banks was, as in many other cases an option, which to choose or not to choose was an outcome of domestic negotiations (s. the case of Netherlands below).

The effective harmonization of accounting rules on a European level was hampered by the large amount of options in the directives. By the early 1990s this fact had caused disillusionment with the method in the European Commission (s. Camfermann and Zeff 2007: 418). Since then, conversations about the formulation of further modernization and possibly common European standards were ongoing, the policy community being in search of an appropriate institutional mechanism (s. van Hulle 1993).

⁹⁵ Hidden loss reserves allow banking regulators to establish a desired level of reserves banks have to withhold the size of which they don't communicate to financial markets. They are supposed to use these reserves to smooth returns, thereby preventing the spread of fear over their solvency after negative market events, which could lead to bank runs. They are therefore a means for the prudent management of liquidity risks inherent in banking, but at the same time diametrically opposed to the goal of transparency as embraced by the IASB for example.

5.4 The challenge of the IASC to the architecture of standards setting and their content

Such a shift in policy became urgent, when European conglomerates started to list on US-capital markets and therefore had to switch to US-accounting standards. The SEC, which considered European accounting standards for consolidated statement as underdeveloped, refused to accept them as equivalent to US GAAP (s. Camffermann and Zeff 2007: 314). This caused problems for large European conglomerates that wanted to access the deep and liquid American capital markets. When Daimler in 1993 broke ranks with other German conglomerates negotiating for mutual recognition of GAAPs and switched to US GAAP, this was a signal for the need for action (ibid; Posner 2010)⁹⁶. It became clear that consolidated accounting statements in Europe needed to reach equivalency status to US GAAP quick or more and more conglomerates would switch. As no European Union member had any influence on the developments of US GAAP, this development was politically unpalatable and another, equivalent accounting framework was sought (s. Camfermann and Zeff 2007: 329).

In this moment, the International Accounting Standards prepared by the International Accounting Standards Council in London, became a serious contender for the project of European harmonization, as their status had risen in 1995 when the IASC and IOSCO, the international association of securities regulators, announced a plan to reach endorsement by IOSCO in 1999.⁹⁷ The idea to push for IAS as European standards was first publicly announced in a policy paper by the EC in November 1995. On the 13th of June 2000 the European Union officially announced its choice of the IAS as an accounting framework to be applied to all companies listed on

⁹⁶ The use of US GAAP by European companies almost doubled from the end of 1993 to the end of 1996 (from 165 to 304, s. Camfermann and Zeff 2007: 329), increasing the pressure upon the European commission.

⁹⁷ Given that the SEC was the predominant member in this body, this seemed to generate the promise of recognition of IAS by the SEC.

European stock markets at the latest from 2005 onwards (s. EC 2000a). The European Commission issued *Directive 2003/51/EC* in 2003 to amend the 4th and the 7th directive on accounting to make it compatible with International Accounting Standards. This directive also dropped the requirement of a capital link for the consolidation for subsidiaries, removing the last barrier to national convergence with SIC 12.

These developments were attentively observed by European nations, which did not want to lose any influence over the accounting standards for their large conglomerates to the US, while at the same time realizing that domestic standards would never be accepted by the SEC. The debate over the future governance of the IAS, where the congregation of national standard setters was seen as likely (s. Camffermann and Zeff 2007: 314) led to an empowerment of national standard setters. In anticipation of this new transnational architecture, domestic standard setting was reformed and centralized in many national accounting standards setting frameworks. The search for voice in international negotiations over European Accounting Standards drove much of these national reforms. Gaining voice in the International Accounting Standards was a large challenge for many continental countries; due to the difference in understanding of who should be involved in standard setting and what should be the goals of these standards.

The International Accounting Standards Council is a project of Anglo-Saxon origin (s. Camffermann and Zeff 2007:3). It was initiated by British auditors in 1973 and staffed with auditors, continuing the tradition of the anglo-saxon accounting professions to set its own standards. With increasing size in the 80s and 90s it sought to include preparers (CFOs of large conglomerates) as well as users (financial analysts) in its organization, but no regulators in

general and no banking regulators in particular.⁹⁸ In line with this constituency the IASC decided in 1989, when it issued its framework for rule making, to dedicate its rules to serve first and foremost the **decision utility of financial investors**.⁹⁹ The framework emphasizes that while there are several classes of users of financial statements, the most important ones are investors, who provide risk capital and financial statements should seek to serve them in their investment decisions¹⁰⁰. Thereby, transparency and comparability of balance sheets which increases the capacity of investors to make informed decisions should be the top priority, dominating other concerns¹⁰¹. They argued that other stakeholders, such as banking regulators, could request additional internal information if unsatisfied with accounting information, a capacity not given for investors. The framework put investors above creditors and transparency above prudence, putting the International Accounting Standards at odds with continental accounting systems such as the German one, which emphasized prudence to protect creditors (s. Kleindieck 2000, Hofer 2007).

Given that the IASB sought the status of an **international** standard setter, their process for decision making could impossibly be based on the congregation of all stakeholders. Instead it was based on a decentralized due process, which involved the publication of exposure drafts of possible rules by the IASB, comment periods and hearings, which ended with the final decision by the independent standard setter. The comments received were taken into account, publishing

⁹⁸ In 2005, after pressure from the ECB and the BCBS, the IASB acknowledged for the first time the role and concerns of prudential regulators with respect to accounting rules when amending the fair value option for banks (s. IASB 2005: 17), interview BCBS officials 03/08/2012, 03/09/2012).

⁹⁹ The argument was that all other relevant stakeholders in accounting have privileged access to information (banks and banking regulators). Only investors, those whose money is at stake in making a decision based on financial accounting numbers don't and therefore deserve particular attention.

¹⁰⁰ In this way, accounting rules will thereby also serve most needs of other users, s. point F 10 of the framework, <http://accounting.e-video-lesson.com/index.php/accounting/acca/14-f7-financial-reporting/284-f7-the-framework-for-the-preparation-and-presentation-of-financial-statements>,

¹⁰¹ This goal to truthfully represent fluctuations in the value of assets and liabilities is the reason for the increasing reliance on market valuation of assets rather than historical cost accounting (s. Camfermann and Zeff 2007: 12).

an extensive documentation as to why a certain decision was taken. This due process emphasizes the independence of the standard setter, but also means that concerned stakeholders can only intervene to a limited degree. This typically British, profession driven way of setting accounting standards, which hands powers to “experts” and institutes a distanced due process in which state officials, unions or other stakeholders have only a very limited influence was challenging domestic frameworks. In particular it was threatening the power of banking regulators to influence the accounting standard setting for consolidated financial statements, on which they however had come to rely due to transnational developments in the realm of banking regulation. In 1979, the Basel Committee introduced the concept of consolidated supervision, based on consolidated financial statements. This move towards a consolidated supervision was motivated by the fact that with the increasing internationalization of banking business, banks had used foreign subsidiaries to evade costly banking regulation (s. Herring 2007: 203). Thus banking regulation increasingly relied on consolidated balance sheets as produced by national accounting standards for regulation. The quality of banking regulation became increasingly coupled to, and limited by the quality of accounting standards and their actual implementation, with respect to capturing all the subsidiaries of the bank, over which the parent bank has control and to whose risk the parent bank is exposed, thereby determining the actual size of the banking conglomerate and its exposure to risk.¹⁰² Determining this size became even more important since the introduction of legally binding core capital requirements¹⁰³, which were first introduced in different European countries and the US in the late 1970s/ early 1980s and became an integral

¹⁰² As explained in chapter 1 (s. the figure “The two scopes of consolidation”), while banking regulators can remove subsidiaries from the consolidated accounts of banking conglomerates, which they deem non-financial, the opposite is not the case. Thus, if subsidiaries remained outside of the consolidated balance sheet of banking conglomerates, their assets would not be considered for the calculation of core capital requirements.

¹⁰³ Core capital requirements establish how much liquid capital a bank needs to withhold with respect to its assets in order to be allowed to operate.

part of the transnational Basel framework for banking regulation in 1988 (s. Tarullo 2008: 40, Singer 2007: 46f).¹⁰⁴¹⁰⁵ The transnational challenges to domestic accounting regulation for consolidated financial statements brought with it the question which role the banking regulator as a major stakeholder of accounting standards should play in their development, which as we will see below led to processes of de- and reinstitutionalization.

On the other hand, the emphasis of the International Accounting Standards Council on economic substance over legal form and its orientation towards principles rather than rules, challenging legalistic conceptions of accounting, had a strong affinity to the “purposive, teleological and consequentialist mode of reasoning” of regulators (Black 2008: p. 26). The rule SIC 12 was therefore favoured by many regulators¹⁰⁶. Moving in the direction of the organizational architecture and procedures of the IASC did not automatically lead to the acceptance of SIC 12-like rules, as it implied the exclusion of a fervent advocate of these rules. Opposing to move into this direction did not mean the refusal of adopting SIC 12-style rules either, quite the opposite as the comparison of the four cases will show.

5.4.1 The Netherlands

The Netherlands have a very peculiar system of accounting standards setting. In its content always very close to Anglo-Saxon accounting standards (s. Choi and Meek 2005: 85), the rules of the Dutch Standards Setter, the Raad voor de Jaarverslaggeving (in the following

¹⁰⁴ Up until the 1970s, banking regulation in most countries was more discretionary, most famously in the UK where it was characterized as club-style self-regulation, which only in 1979 was raised to a statutory level (s. Moran 1986, 1991, 2003).

¹⁰⁵ This calculation of core capital charges was to be based on the consolidated financial statements, to which certain off-balance sheet items (such as lines of credit) were to be added (s. Kapstein 1991).

¹⁰⁶ Commenting on the US rules for consolidation, a manager of the Fed stated: “I am not sure we were thrilled with the outcome; as I said we tend to be more risk focused, so we liked the IFRS standards, that had a risk and reward overlay, we liked that approach, and we kind of hoped the FASB would do something similar” (interview Fed manager responsible for accounting,

RJ) are non-binding for the corporations in their accounting decisions. Auditors do not report on compliance to these rules and in 1990 there were only 2 out of 119 companies that stated that they were in compliance with Dutch GAAP (s. Camfermann and Zeff 2007: 414). Besides the few accounting rules specified in the Dutch Civil Law, which are binding, the question if the consolidated statements depicted a conglomerate truthfully could only be decided by judicial review after contestation by shareholders in a special court.¹⁰⁷ Commenting on that period, a Dutch regulatory advisor remarked:

Dutch GAAP was a very loose, block of regulation, my American colleagues said you can drive a truck through all the possibilities of Dutch GAAP, it has so much room to manoeuvre, it has so much element of choice (interview Amsterdam 10/06/2011)

This lack of enforcement capacity in the domestic framework, however, did not apply to banking conglomerates in the period from 1979 and 1993. In 1978, with the revised Act on the Supervision of the Credit System 1978, which went into force on 1 January 1979, it was specified in Section 11.2. that “The Bank (DNB) shall, after consultation with the representative organizations concerned, lay down the model for the annual accounts, which may vary for different groups of credit institutions.” The 1978 law was a direct consequence of the first EC directive on the coordination of laws and regulations concerning credit institutions (77/780/EEC), formalizing the system of banking regulation in the Netherlands for the first time (s. Morgan and Quack 2000: 146). While not unlimited¹⁰⁸, the DNB had a large degree of power over how banks would report their balance sheets to the regulator and which rules they should apply.

¹⁰⁷ This court was the enterprise chamber. This lack of enforcement capacity and support in the domestic framework lead Zeff, van der Wels and Camfermann (2002) to the judgement that the Dutch standard setter is not a standard setter of international importance, as it neither has the means nor the capacity for enforcements even in its own country.

¹⁰⁸ Note the reference to consultation, which included also the general accounting standards setter (interview former president accounting standard setting body Amsterdam, 08/16/2011).

This great degree of power over the accounting framework for banks was reduced to an informal role in 1993. With the implementation of EC 86/635¹⁰⁹ into Dutch law in 1993, a Directive seeking to harmonize the consolidated statements of banking conglomerates, a specific chapter for the financial statements of banks was introduced into general Dutch law (Chapter 14, Title 9 of Book 2 of the Dutch Civil Code). In this new legislation there was no formal role left for the DNB. This decision in 1993 ended the role of the DNB in the subcommittee of the Dutch Accounting Standards for all accounting standards concerning banking conglomerates, a role which had diminished since the second half of the 1980s. In the process of the increasing orientation of the Dutch accounting standard setter towards investor oriented accounting, the DNB lost much influence until the early 1990s over the goal conflict between prudent and neutral accounting:

Former president accounting standard setter: We have sometimes, we have had some discussions with the central bank, because the bank wanted to influence Dutch accounting standards for banks from their supervisory role; well in fact we have sort of decided that these are split roles, that the central bank has its own requirements on information from banks for their supervisory role; but that should not influence the accounting standards ... that was 1984 or something, and then... it was finally decided that there was a different perspective from the banking supervisor and the accounting standard setter, the accounting standard setter is directed at many users and the bank is able to ask for more information if they want and especially they of course they were being more interested in prudence and conservatism, while the dutch accounting standards board said we like, we want neutral accounting and not prudent accounting because the Dutch central bank wants prudent accounting.

While this conflict first erupted over the measurement standards of banks, which was decided in favour of uniformity across all different groups, it left a certain policy instrument untouched.

Former president of the standard setter: they (De Nederlandsche Bank, M.T.) were part of the special committees preparing standards ... and then there was a discussion between people in that special group preparing standards ...and then this sort of discussions came into the general meeting of the RJ, because there was a sort of difference of opinion of how to deal with the measurement standards of banking **and**

¹⁰⁹ EC 86/635 is a directive that seeks to generate harmonization of the accounting rules for banking conglomerates with all other rules.

in that discussion it was decided that the view of the Dutch central bank would not be applied in accounting; there was one issue that was changed later on, that we did accept, because the supervisor, the Dutch central bank wanted that. **That was that you could have sort of secret reserves to prevent a run on the banks in the case banks would take losses.** And that was a secret reserve that did not meet the requirements of general provisions (interview former Dutch Standard Setter, 08/16/2011).

The role of the DNB in standard setting, which was already largely diminished by 1990 came to an end in a dispute over these undisclosed loss provisioning for banking conglomerates, which was a central component of the special accounting regime for banks the DNB had instituted¹¹⁰. These loan loss provisions were the last foothold that the DNB had in the Dutch accounting standards, and given that the EC Directive EC 86/635 permitted hidden loan loss reserves for banking conglomerates as an option, the Dutch Central Bank sought to maintain this hidden loss reserve in Dutch accounting. In this attempt it was defeated by the Dutch Accounting Standard Setter, which, due to its influence convinced the ministry of justice to change the laws in their favour (interview former president accounting standard setter 08/16/2011).

...And there has been a lot of discussion with the central bank, but finally, I do not exactly know the year, but **finally we decided that transparency would be more important and that we would not accept it anymore and also the ministry of justice changed the law saying that a provision against general risks was not appropriate,** only a reserves would be acceptable (interview former president Dutch standard setter 08/16/2011)

It meant the abandonment of the idea of prudence as a substantial component in making accounting standards, as the accounting standards setter explains:

interviewed: yes, that was prudent from a monetary system perspective and a banking system perspective, so that people would not be thinking that if there was a large loss of the bank, which would of course result in the bankruptcy of the bank and in the possible run on the monetary system, so to prevent that. It was that we should use financial reporting for that reason but it was later abandoned that idea“

¹¹⁰ Until 1993 these provisions were included as a liability under Creditors, and from 1993 to 1998 as a deduction from the asset side,

The final exclusion of prudence as a point of concern in accounting standard setting came with the convergence of goals of the Dutch standard setter with the International Accounting Standard Council in 1996. The Netherlands, as a relatively small economy were in favour of internationalization of accounting standards in the early 1990s (interview former president of the Dutch association of auditors, 03/08/2012), but there was no official encouragement of IAS and the largest conglomerates were leaning towards US GAAP. The due process in the development of accounting standards consisted of discussing the standards in subcommittees with experts from the field, a comment letter period and the final discussion of the standards in the general assembly that excludes the government, where votes are distributed to preparers of financial statements –industry-, auditors and unions, with preparers and auditors being the main drivers of the process (interview Dutch auditing association, Amsterdam, 07/05/2011). The due process has been close to the IASC, with exposure drafts prepared by working groups and exposed to comment periods, after which final decisions were taken by the standards setter. In this configuration, the Dutch Central Bank could still be part of the working groups/special committees. However, the alignments of the goals of the Dutch Standards Setter with the goals of the International Accounting Standard Setter, which culminated in the direct translation of the conceptual framework of the IASC from 1989 (Framework for the Preparation and Presentation of Financial Statements) into Dutch in 1996 sealed the exclusion of the Dutch banking regulator from the policy network. The sole focus of the framework on the concerns of investors meant that after this decision, any link between the DNB and the standards setter were severed, the DNB did not maintain any active position or link with RJ (interview former leading standard setter in the Netherlands, 08/16/2011). This development had important implications for the way

the information generated by a rule similar to SIC 12 would be used by the Dutch Central bank, once introduced.

The transition to a SIC 12 style rule

When in 2000 it had become clear that the International Accounting Standards were becoming the accounting framework of reference for large Dutch conglomerates, the Dutch standards setter became a rather reactive member of the standards setting community, as its work mostly consisted of considering the latest standards of the IASC/IASB for translation into Dutch GAAP, analyzing its potential impact on the Dutch economy (interview Dutch auditors association 07/05/2011).¹¹¹ In 2001, after reviewing the SIC 12, the RJ decided to translate it and include it into its Guidelines for Annual Reporting (s. Guidelines for Annual Reporting 2001, chapter 2.14 Article 203 and 203c., today these same paragraphs are in Chapter 217, article 204 and 205). This early introduction was made possible because the Netherlands, as the only country, had applied the option in the 7th directive to drop the capital link as a consolidation requirement for all Dutch conglomerates (s. European Commission 2000b: 6). This decision was in line with the principle of the true and fair view which Dutch accounting endorsed.

The processes of isomorphism from the transnational to the national level had led to the exclusion of the banking regulator from accounting standard setting. When a SIC 12-like rule was introduced in the Netherlands, it had no implications for banking conglomerates in terms of core capital requirements, because the the DNB had decided in close dialogue with the banks, their financial advisors and the banking regulators in the US and the UK that consolidation should have no implication for core capital requirements (interview bank manager Netherlands,

¹¹¹ Zeff, van der Wels and Camfermann (2002) judge that the Dutch standard setter had effectively become an importer of international financial standards.

12/06/2011). The DNB had decided to focus on securitization transactions alone, granting off-balance sheet status to securitization transactions if a substantial risk transfer had occurred. This framework however, could not capture securities arbitrage conduits, where the banking sponsor itself is not transferring any assets, but instead orders the SPE to buy assets from other sellers. Although it noticed the introduction of the standard (interview DNB 10/05/2011) the DNB did not appreciate the reasons for consolidation that standard could force consolidation upon banks, the majority of risks and rewards , a perspective most akin to banking regulators.¹¹² Being disengaged from the standard setting activity, it instead followed the suggestions of its American and British colleagues and the banks themselves. This was not a stance shared by all banking regulators, and it decisively relates to their role in accounting standard setting. We find a very different development in the French case, where the banking regulator maintained a central position in the standard setting procedures and championed the early convergence with SIC 12, using it for core capital requirements the moment it was introduced.

5.4.2 France

The French standard setting process for industrial corporations since the Second World War is dominated by two special characteristics. First the fact that many different stakeholders are included in the process of standard-setting and second, that these standard setting procedure were undertaken in a collegial style, meaning that the due process did not include the issuance of exposure drafts of standards, granting concerned stakeholders the capacity to write comment letters. Instead, all relevant stakeholders were to be included in the Conseil National de la Comptabilité and there they were supposed to debate the standards until a new standard could be

¹¹² In contrast, American banking regulators, which entertain a strong relationship with their accounting standard setters were in favour of such a risk and rewards approach.

formulated (Hoarau 2010: 312)¹¹³. This need to include all stakeholders and the need for lengthy debate, however, severely hampered the efficiency of the body due to the lack of expertise and number of members (interview member CNC 01/27/2011, interview ordre des experts comptables, 03/21/2011). The inadequacy of French accounting standards was acknowledged in 1998 by granting French conglomerates an option to exclusively apply US GAAP or IAS for their consolidated financial statements (loi n° 98-261 du 6 avril 1998, article 6, s. Hoarau 2010: 316). At the same time, institutional changes at the CNC in 1996 and 1998 aimed at streamlining the process by reducing the numbers of members and increasing the speed of operations. In reforms in 1996 and 1998, the membership of the CNC was reduced by half and the CNC gained standard setting powers via a new committee, the Comité de Règlementation Comptable (CRC). Formerly, the CNC could only issue advice and depended on the translation of this advice into regulations by the government. In addition, different standard setting regimes were united in the CNC, including the accounting standard setting for banking and insurance standards (s. Hoarau 2010: 316). Until then, accounting rules for banks and other financial institutions were written under the auspices of the banking regulator in the Comité de la Règlementation Bancaire et Financière. While the special accounting standards for banks and insurances remained in force, new standards were now to be debated and set in the CNC. These reforms therefore implied a large upgrading in terms of the power for the national accounting standard setting body, an upgrading motivated by the need for quicker and more efficient standard setting (ibid).

Furthermore, the role of the president of the CNC was strengthened by turning it into a full-time position, which permitted no other activity (except teaching and participation in

¹¹³ Hoarau speaks of « une très grande diversité de parties prenantes ou d'intérêt représentés au sein de l'organisme de normalisation » et « un mode d'élaboration de la norme fondé sur une collégialité délibérative » (ibid)

international bodies, s. Hoarau 2010: 317) In 1996, for the first time the president was no longer a former state employee, but instead a former partner at Arthur Andersen.¹¹⁴ That person, Barthès de Ruyters, was also a former president of the International Accounting Standards Committee (from 1987 to 1990)¹¹⁵ and favoured speedy convergence with the international standards (interview Order of French Accountants, Paris 03/21/2011). So did the Finance minister, Mister Arthuis who himself was a former partner of Arthur Andersen and had appointed Barthès to the presidency of the CNC (s. Camffermann and Zeff 2007: 410). Their work was facilitated by the fact that consolidated financial statements were quite underdeveloped in French accounting standards (ibid).¹¹⁶

While the banking regulator's predominant role in accounting standards setting for banks was deinstitutionalized, its role in accounting standard setting became re-institutionalized in the general standards setting body. It changed its position in the CNC from observer to member and became a leading member in the subcommittees dealing with the accounting standards of greatest concern to banking conglomerates (interview member of CNC working group for banks, 03/22/2011). In this sub-committee, auditors, financial regulatory agencies and the banks negotiated new rules, in a setting that featured monthly discussions into the late evening, seeking to reach a consensus that is guided by the commission (interview banking manager and member

¹¹⁴ This choice of former auditing partners as presidents lasted until 2007, when Jean François Lepetit, at the same time a banker and an experienced regulator was appointed and was completely abandoned with the installation of Jerome Haas, a former treasury official in 2010..

¹¹⁵ The new president of the CNC turned out to be also a good pick for the CNC in terms of its finances. As Barthès de Ruyters was the vice-president at the ordre des experts comptable before he became the president of the CNC, he decided to close down the technical committee at the Ordres and instead to support the CNC financially. The Compagnie Nationale de Commissaire aux Comptes joined, and together supported the CNC annually with 1.5 million francs annually (interview ordre des experts comptables, Paris, 03/21/2011).

¹¹⁶ As a consequence of this political decision-making, the liaison member of the French delegation at the IASC, Mister Gélard, also became a member of the CNC in 1998, working on the translation of International Accounting Standards into French accounting standards.

sub-committee, Paris 03/25/2011, interview with 2 officials of the CNC, Paris 06/02/2010¹¹⁷). The participation of private actors in this committee is free of charge for the state, but these actors pursue their self-interest (interview state official at the CNC, 04/30/2011). The fact that the French banking regulator was so centrally involved in the standard setting process guaranteed that these standards were often in accordance with prudential preferences. The goal of the accounting department of the banking regulator in these negotiations was “to pass accounting rules which are amenable to the goals of prudential accounting” (French Banking regulator Paris 02/03/2011).

One of their most significant achievements in this respect was the convergence of the French standards for the determination of the boundaries of banking conglomerates with the SIC 12. The French standard setting body was passing two rules in 1999 and one in 2000 concerning consolidation, all modelled according to SIC 12 but with certain deviations. The first rule, CRC 99-02¹¹⁸, applies to all companies, except for banks and insurance companies; it is almost identical to SIC 12, but it requires a capital link between mother and subsidiary (in accordance with the general provisions of the 7th EU directive) and it requires that both the majority of risks and rewards are with the sponsor, whereas in SIC 12, the majority of either of the two is a sufficient reason for consolidation. This convergence was one of the first results of the presidency of Barthès de Ruyters and his efforts for convergence, with the president being often present himself at the meetings of the working group for consolidation (interview member CNC 01/21/2012).

¹¹⁷ “Yes, they absolutely have the possibility to express their opinion. And it is there that I told you: we produce consensus. But evidently if they cannot agree, if the bankers say one way and the insurers another, then it is the commission that decides.” « Oui, ils ont absolument l’occasion d’exprimer leur opinion. Et c’est là que je vous disais : on fabrique le consensus. Alors évidemment, s’ils n’arrivent pas au consensus, que les banquiers tirent à hue, les assureurs à dia, à ce moment là, c’est la commission qui tranche. » (high functionary CNC 06/02/2010)

¹¹⁸ CRC refers to the comité de la réglementation comptable, a smaller body inside of the CNC which transposed proposals by the CNC into law. The full text of the CRC 99-02 can be found at <http://www.articles.exafi.com/compta/ComptaTextes/CRC99-02.htm>

The second rule, CRC 99-07¹¹⁹ applies only to banking conglomerates. Building on the efforts at convergence of 99-02 it is similar in all respects to 99-02, but drops the capital link. It was crafted in the special committee for the banks and the input of the banking regulator was central, as a member of that committee at the time confirms. The former member added that regarding this specific rule, the prudential regulator was fighting in the subcommittee of the CNC to make the standard for off-balance sheet accounting as strict as possible.

“It was the CNC who formulated it, but I would say for the 10052 (the part where risks and rewards are introduced, M.T.) the input of the Commission Bancaire for the 99-07 for the banks was primordial, one can say that, it is evident... the 10052 for the banks this is where the Commission Bancaire has pushed, so that it became, later we changed that, but first it was risk and reward. ... While I recall debating until midnight over fair value of loans, which is in 99-07, I don't recall too much discussion on 10052 for the banks, all of that because it was however the Commission Bancaire which was the leader on that” (interview Auditor big four Paris, former member of the CNC working group for banks, 03/22/2011)

Writing different rules of consolidation for different segments of industry (another standard was published in 2000 for the insurance sector) reflected a continuation of the different regimes of accounting which had existed before 1998. This continuation allowed the banking regulator to almost completely converge the accounting rules for banking conglomerates with SIC 12, while this was not possible for all conglomerates due to the way the 7th European directive on accounting was implemented in France. The Comité de la Réglementation Bancaire et Financière in the 80s decided to use the option in the 7th directive in Article 1.c. to drop the requirement of a capital link for banking conglomerates when amending the monetary and financial code (s. Bulletin Officiel du CNC n°119, 1999:9¹²⁰). The banking regulator at the time

¹¹⁹ The French text can be found at <http://www.bibliobaseonline.com/notice.php?NUMERO=55893&OLD=103092>

¹²⁰ The French text can be found at http://www2.budget.gouv.fr/fonds_documentaire/CNCompta/bocncompta/119.htm

chose to use that option as it was concerned by the degree of financial engineering which already existed at that time:

“Historically, you have the general law behind the commercial law which applied to industrial and commercial enterprises, on the contrary for banks there were other texts which applied, what is called the monetary and financial code and so the directives were transposed with certain nuances between the commercial and the banking sector. We took the 1983 original text, there was already in that text an option to not require a capital link, ... in general one consolidated with a capital link and otherwise not, but for the bank it was considered that given the financial engineering which already existed at that time, one possibly had to foresee cases where the capital link was not the case. So effectively this was different (interview CNC, with former employee banking regulator, 01/30/2011)

When leading the charge for convergence of French GAAP with SIC 12, the French banking regulator could point back to that decision and argue that accounting rules for banking did not fall under the general accounting rules specified in the commercial law, but instead were based on the specific regime of rules decreed by the Comité de la Réglementation Bancaire et Financière. French accounting norms, as applied to credit institutions were therefore almost equivalent in text to SIC 12 in 1999. In September 2000, the Comité de la Réglementation Bancaire et Financière translated this accounting norm into prudential regulation in the “Règlement n° 2000-03 relatif à la surveillance prudentielle sur base consolidée”¹²¹. Thus using the information generated by the accounting norms for prudential regulation, made the engagement of French banks in the ABCP market more costly than those in the US, British or Germany. **The immediate use for core capital requirements is an important demonstration of the power of the linkage between accounting standards setting for banking conglomerates and their use for prudential regulation.** But, as said above, the new 99-07 was only almost a literal translation of SIC 12, and its exact implementation in the banking community and by auditing networks would involve a fight over this regulation which would

¹²¹ The French text can be found at http://www.banque-france.fr/fr/supervi/regl3e_bafi/textvig/reg6_2003.htm.

unfold in the years between 2002 and 2005, which first would lead to a tightening of the standards, and then a relaxation.

In 2002, the French banking regulator and the securities market supervisor, startled by Enron, issued a recommendation which tightened the interpretation of 99-07 to a significant degree, by moving it even closer to SIC 12. Now the detection of either a majority of risks or of rewards could lead to consolidation, (the reasons which motivated the two regulators to issue the recommendation, in how far it was binding and what it reveals about the French mode of regulation will be discussed in the next chapter). This intervention by the two regulators, which led to the need for significant restructuring for the French banks sponsoring ABCP conduits (interview French Bank manager, 03/25/2011), violated the turf of the national accounting standards setter, which caused annoyance in the CNC (interview official working at the CNC at the time, 04/30/2011). In addition, it became problematic for the entire ABCP-business of French banks, once the capital link as a necessary criterion for consolidation was dropped for all corporations in 2003.

In this year, as a reaction to Enron, the Sarbanes and Oxley Act in the US and the Directive 2003/51/EC, the French 'loi de la sécurité financière' (law of financial security) dropped the capital link as a consolidation requirement for all French corporations and requested the convergence of the general rules of consolidation (99-02) to converge with the rule for banking conglomerates (99-07) (interview IASB standards setter, former AMF official, Brussels, 06/10/2011). In the interview, the former AMF-official described the situation in 2003 as a unique window of opportunity, which he exploited to bring about the dropping of this link in the law, in line with the recommendation the AMF had issued a few months earlier. In the same interview, the official also stated that under normal circumstances this drop would not have been

possible due to the opposition of the conglomerates concerned (interview IASB standards setter, former AMF official, Brussels, 06/10/2011).

This convergence of the two rules in conjunction with the recommendation of 2002 however threatened to derail the short-term securitization business of banking conglomerates with respect to their multi-seller units, as the old agreements between corporations selling their credits to ABCP conduits and banking conglomerates was no longer viable. Before 2004, when the new rules were instituted, corporations could supply a certain amount of guarantees for the credits they had sold, and thereby make sure that the majority of risks and rewards did not reside with the banking conglomerate. On the other hand, they did not have to consolidate these conduits either, as the lack of a capital link between the corporation and the ABCP conduit made this impossible. With the rule changed, corporations suddenly faced the possibility of having to consolidate these conduits, as they maintained the majority of risk exposure to the conduits. This possibility was diametrically opposed to their primary business goal they had when undertaking securitization, the shortening of their balance sheets. On the other hand, banking conglomerates were not willing to assume the majority of risks, due to the threat of consolidation on their balance sheets combined with the ensuing capital requirements (interview former CNC official involved with the rule changes and the debates surrounding it , 04/30/2011).

This impasse threatened the entire market, and thereby a goal of the government to further ease credit constraints via securitization (interview economic advisor to the French president, 03/11/2011). The success of the two regulators to sharpen off-balance sheet regulation was in this way the foundation for a concerted effort to relax that regulation by an alliance of the ministry of the economy, industry and banking conglomerates in order to revitalize the ABCP business. To resolve this problem, the French standard setter CNC included a special provision

for securitization SPEs, when it implemented the ‘loi de la sécurité financière’ and broadened the conditions of the rule 99-07 to all corporations in 2004. While all other SPEs had to be consolidated, if a majority of risks and rewards resided with the parent company, this fact only established a rebuttable presumption of control for securitization-SPEs according to the new rules. This rule change was intended to create a loophole for non-banking conglomerates to continue their practice of granting guarantees without facing the threat of consolidation of ABCP-conduits (interview member of the CNC subcommittee on this issue, 03/22/2011). When the working group in the CNC that formulated this rule change (constituted by bankers, auditors, the financial regulator (AMF) and the banking regulator) voted on it, the banking regulator abstained. A former banking regulator recalls:

“the regulation of 2004, the Commission Bancaire refused to vote on it, the regulation of 2004 which is voted by the CRC is without doubt the only time that the Commission Bancaire abstained, which means that we were not too favourable towards the text” (interview former banking regulator, Paris, 01/30/2011).

Short of outright confrontation by rejection, which is unusual in a forum that seeks consensus, the abstention was the biggest possible sign of opposition the banking regulator could send. Accordingly, a banking manager describes the event as a defeat for the banking regulator (interview Paris 03/25/2011), and the banking regulators involved admitted defeat on this question (interview banking regulator 02/03/2011, interview CNC with former banking regulator 01/30/2011). As a member of the CNC put it, these changes were inconceivable unless the finance ministry was in accord with the banks and industry (interview member CNC 01/27/2011). The new measure was imitating the US construct of the Qualifying Special Purpose Entity which allows specific securitization SPEs to be treated as stand alone corporations, which

are not consolidated into any other balance sheet.¹²² It was doing so in order to allow French banks to compete with their American counterparts, a fact alluded to in the first note for public presentation of the new rules, which states “the will of the CNC not to systematically include in the perimeter of consolidation securitization transactions, in order not to threaten the economic advantages stemming there from, and this for reasons of international distortion of competition” (CNC 2004: 2¹²³, translation M.T.).¹²⁴

In fall of 2004, the interpretation committee of the CNC, the Comité d’Urgence was issuing the Avis D¹²⁵, an interpretation which clarified how corporations could refute the presumption of control generated by the majority of the risks and rewards and thus the consolidation of securitization SPEs on their balance sheet under certain specific circumstances.¹²⁶ This comité d’urgence which acts upon request by the ministry of the economy or the president of the CNC is composed of the president of the CNC and 6 vice presidents, the representatives of the ministry of the economy, the ministry of the budget and the ministry of justice and members of the Autorité des Marchés Financiers (s. Hoarau 2010: 317). Notably, it does not include a member of the banking regulator, thereby removing the final decision from

¹²² A banking regulator involved in these negotiations spoke of the recurrent theme of Qualifying Special Purpose Entities in the US, brought forward by the advocates of the rule change (02/03/2011), a theme confirmed by a former banking regulator (01/30/2011).

¹²³ s. note de presentation, accessible at

http://www.cnc.bercy.gouv.fr/fonds_documentaire/reglementation/avis/avisCNCompta/2004/note_avis0408-09-10.htm

¹²⁴ “International distortion of competition” refers to the competitive situation of French banks with respect to foreign competitors offering securitization services that could accept the majority of risks and rewards because their banking regulator had exempted consolidated ABCP conduits from core capital requirements and instead applied a substantial risk transfer framework (e.g. Netherlands or Germany).,

¹²⁵ The text of the note de presentation of this avis D can be accessed at

http://www2.budget.gouv.fr/fonds_documentaire/reglementation/avis/avisCNCompta/comiteurgence/note_cu04d.htm

¹²⁶ These four circumstances involved the contracts between the party which is selling debt contracts to an SPE that it will not repurchase these contracts, that it will not become itself the sponsor of the conduit, that the guarantees it gives for these debt contracts are limited and that the conduit can change the agency which is supposed to collect these debts. (s. CNC 2004 Avis D, source in footnote above)

the potential veto of the Commission Bancaire. Nevertheless, the banking regulator joined the working group that prepared the text in order to prevent the worst.

“Yes, I remember how that happened, the guys that participated from the Commission Bancaire, their goal was to limit what was possible, as we nevertheless saw that this development was not good, ... we said that we will switch to IFRS next year and that it did not count, ...it is true that the comité d’urgence made its specifications, ... we said to limit, not to allow too much deconsolidation, knowing that the texts would not be applied or sparsely” (interview former banking regulator, 01/30/2011)

This episode clarifies the loss of power the Commission Bancaire had suffered in 1998, when the capacity for setting accounting standards for banks were withdrawn from it and placed into the CNC, where the Commission Bancaire now had to negotiate, in addition to the banking conglomerates, with the ministry of the economy and the budget, which were directing the work of the CNC (s. Hoarau 2010: 316). The Comité d’urgence, newly installed in 1998, was the pinnacle of this loss of power, as the banking regulator was excluded from voting there. The fight ended in 2005 when the banking regulator decoupled the decision over the application of core capital requirements to SPEs from accounting decisions, a decision which I will analyze in greater depth in the next chapter. This open struggle between the ministry of finance and the banking regulator over accounting rules for securitization stands in sharp contrast to the German case, where the regulator is subordinated to that ministry and where there was no tradition of any involvement of the banking regulator in accounting standard setting. As a result, those favoring convergence with SIC 12 in Germany would not be modernized were lacking an important ally and would only have success after the financial crisis.

5.4.3 Germany

In Germany, the institutional framework concerning the standard setting for accounting norms was entirely different than in France or in the Netherlands. Before 1998, there was no specific standard setting body for accounting norms; instead changes to the accounting norms in German commercial law were undertaken by the Ministry of Justice, in close coordination with the large business associations and the concerned ministries. The result of this sparsely populated policy network with few resources allotted to accounting standard setting were very few very large projects, such as the modernization of the accounting rules in 1985 and then again in 2009 (interview German accounting professor, 06/30/2011). There was no independent standard setting body. In the realm of consolidated financial statements, the German auditors association (IDW) informally filled this void by providing statements on questions of accounting (called HFA RS). Its power to do so stemmed from the fact that consolidated statements had no importance for tax or profit distribution considerations in Germany, and therefore there were no other judicial forces clarifying matters. A board member of the IDW explained:

“the institute of German auditors has never understood itself as a standards setter, but de facto this was the effect, as there was no other place which had the same kind of acceptance and power,...this professional view is developed in a due process, and the auditors are bound by it (interview Berlin 05/03/2011)

This weakly institutionalized framework would be reformed to answer the transnational pressures, which emanated from the lack of recognition of German GAAP in US capital markets. In order to lower costs for German conglomerates issuing stocks and debt in this market, a law in April 1998 (Kapitalaufnahmeerleichterungsgesetz) allowed conglomerates to prepare their consolidated financial statements in US GAAP or IAS only, making a statement according to

German GAAP unnecessary. In the same year, the ministry of justice was granted the permission (with the law §342 of the HGB) to sign a contract with a private standard setting body, whose tasks were to issue recommendations on interpretations of domestic standards, to offer advice to the ministry of justice on reforms to improve the rules for consolidated accounts¹²⁷ and to represent Germany in international accounting standard setting bodies. At that time, the governance of the IASC was seen as moving towards a body of national standards setters (s. Camfermann and Zeff 2007: 412f) and the German standards setter was set up to provide an answer to the question “where the German private standards setter was” (Benston et al 2006: 130).

The ministry of justice chose §342a which envisioned the private standard setter over its alternative (§342b), which had envisioned a collegial style standard setter including the financial and banking regulator, the ministry of justice as well as the finance ministry. It did so for three reasons. First, the goal of gaining influence at the IASC was seen as endangered through the inclusion of state organs in an accounting standard setter, when the predominant Anglo-saxon model was one of an independent body of experts (interview German financial regulator, 07/01/2011, interview board member German auditors association, 05/03/2011). Having the state inside of the standard setter that was to represent Germany in the IASC could endanger the standing of that body at the IASC, which according to requests by the SEC was to be modelled as an independent, apolitical expert body (s. Camfermann and Zeff 2007: 14). Second, cost considerations seem to have played a role.¹²⁸ The task of the German Accounting Standards

¹²⁷ At the time of its founding, there were expectations of a large scale reform to converge the rules for consolidated financial statements upon IAS, if possible until 2002 (s. Biener 2000: 63).

¹²⁸ That these cost considerations played a role becomes clear especially during the existential crisis of the DRSC in 2010. In that year, the GASB one-sidedly cancelled the contract with the German government regarding its standard setting activity, with the argument that adequate financing was not secured. In the ensuing negotiations the German government persistently refused to provide any funding, pointing instead to industry (interview German standard setter, 05/03/2011).

Board DRSC to represent the interests of German industry at the IASC provided the justification for to place the entire costs of the German standard setter upon German industry. A final reason for the ministry of justice to opt for the private standard setter might have resided in the unwillingness of the ministry of justice to share its powers in the standards setting process, as would have been the case with the new council. With the new private standard setting body, all legislative powers remained with the ministry of justice (interview with an official ministry of justice, 05/04/2011). This means that at a critical juncture in the transformation of the German policy network, transnational pressures and the clinging to power by the ministry of justice led to the decision against the inclusion of the banking regulator, although the latter directly depends on German accounting standards for its supervisory work.

This continued predominance of the ministry of justice was to severely hamper the convergence efforts for domestic GAAP by the DRSC. While the German standards setting body did not face any state interference when submitting comment letters to the IASC/IASB, it was dependent on state approval for changing domestic standards. Standards by the DRSC remain mere suggestions without the approval of the ministry of justice, which has to publish the standards in the organ for law announcements. This leads to a constant exchange between the two bodies, with the representative of the ministry of justice attending some board meetings, reading the development of the texts and flagging when problems arise. The new standard setting body was further weakened in its power by competition with the national body of auditors (IDW), which had issued recommendations for standards before and felt animosity towards the new body (interview auditor and member of DRSC 02/21/2011, interview at the IDW with IDW officials, 04/14/2011, interview board member IDW 05/03/2011). The IDW, which has much greater financial capacities as well as greater manpower than the DRSC put neither of these two

at the behest of the standard setting body (in contrast to France). Instead, the IDW sought to limit the powers of the standards setting body¹²⁹ and to dictate the agenda of action for it.¹³⁰

In addition to this legislative weakness and lack of general support from the IDW, the German standard setter is not the only advisory body for the reform of accounting standards. The ministry of justice is required by law to consult with the federations of industrial and commercial enterprises in the law making procedures (common procedures of the German ministries¹³¹). This German specificity gave industry associations more veto power to stave off the more restrictive rules regarding off-balance sheet financing, by allowing them to intervene twice, at the standards setter as well as at the ministry of justice.¹³² This increased number of veto points, in conjunction with a lack of coordination between banking regulator and DRSC proved decisive in stymieing any efforts of convergence of rules for consolidation with SIC 12 up until after the financial crisis.

The failure of modernization

In December 2001, the German Accounting Standard Setter tried for the first time to converge the German standards for consolidation with SIC 12. This attempt was motivated by the failure of Enron in the fall of 2001 and reactions to it in the auditing community (interview official of the German standard setting body, 12/11/2010). The DRSC issued a ‘lege ferrenda’

¹²⁹ This rivalry manifested itself when the DRSC as one of its first acts was trying to eliminate options in the accounting framework for individual corporate statements by issuing specific interpretations of the HGB, acts which the IDW regarded as presumptuous and declared informally to the auditors did not need to be followed by German auditors (interview board member IDW 05/03/2011, German standard setting body 05/03/2011).

¹³⁰ The final agreement between the two that came about in the early 2000s was that the IDW would withdraw its exposure drafts on recommendations, if the DRSC takes up the topics the IDW perceives as important and handles them in an appropriate manner (board member IDW 05/03/2011), which demonstrates the power of the IDW to set the agenda.

¹³¹ For the German law specifying this rule, s.

http://www.bmi.bund.de/SharedDocs/Downloads/DE/Veroeffentlichungen/ggo.pdf?__blob=publicationFile

¹³² This fact of two due processes became the most evident, when the DRSC had finished the due process for the standard on management board compensation, only for the process to be reopened by the ministry of justice, requesting input from associations for a second time (interview German standards setter, 05/03/2011).

(desired legislation), which requested from the ministry of justice convergence of German norms with SIC 12 in German law (s. E-DRS 16). Reactions were mixed to the draft; while some auditors greeted the proposed innovation, leasing firms and the federation of Chief Financial Officers virulently opposed the changes as introducing contested accounting rules into German standards and criticizing the endangering of the leasing business model (s. the respective comment letters at the website of the DRSC¹³³).

In a remarkable deviation from its French counterpart, the German banking supervisor was lobbying the Ministry of Justice directly on this issue, opposing quick rule changes. It urged a longer rethinking of complex legal changes involved in treating the autopilot mechanism (which was installed by banks to prevent consolidation) and alluded to the fact that changing the rules for consolidation might have an impact on the core capital of banks in prudential regulation, the exact size of which could not yet be estimated¹³⁴. In Germany, capital requirements for the assets of banking conglomerates are to this day directly linked to the rules for consolidated financial statements as established in the code of commerce (the Kreditwesengesetz § 1, Nr. 7 explicitly refers to the German accounting rules for consolidation), which gives changes in the commercial law book (HGB) a special political importance.¹³⁵

If this intervention was motivated by regulatory capture is impossible to ascertain, especially given the non-transparent language used in the letter that can be interpreted as opposition or mere hesitation regarding the measure. What can be ascertained is the degree of surprise this proposal caused at the BaFin. Rather than being informed about the proposal before its

¹³³ Available at

http://www.drsc.de/service/docs/index_en.php?ixdiox_do=show_docs&type_id=2&cat_id=10&base_doc_id=16

¹³⁴ The german text can be found at <http://www.standardsetter.de/drsc/docs/comments/016/bakred.html>.

¹³⁵ This linkage of (non-modernized) commercial law and credit law translated into a total de-recognition of assets in ABCP conduits in prudential terms up until the German Accounting Law Modernization Act (Bilanzrechtsmodernisierungsgesetz), modernized the accounting rules in 2009 (interview with Bundesbank officials, 12th of August 2010, Frankfurt/Main).

publication or even being part in its formulation by being asked for input, the regulator is confronted with the proposal once it is already published. Instead of having the time to calculate how much new core capital the consolidation of special purpose entities would provoke beforehand, they are asked to give an input when they do not have a data basis for such an input. This interpretation of surprise was sustained in an interview at the financial regulator, where the two officials emphasized the length of time an inquiry into the impact of new consolidation rules on core capital takes and the difficulties of assessing these issues without data prepared by the banks themselves (interview financial regulator Germany, 07/01/2011). Whereas the French banking regulator was behind this drive for convergence from the beginning and had an understanding of the changes to core capital requirements such a law change would bring, the German regulator was surprised by it.

This surprise can be linked to the way the GASB was set-up, modelled along the IASC template, in line with the goal of gaining legitimacy and influence at the IASC. The members of the council of the DRSC are all either auditors or preparers of financial statements and there never have been any state officials inside the body. The due process for setting standards is started, just as in the case of the IASC with a draft of the rule by the standard setter. In this constellation, there was no stable link with the banking or financial regulator, indeed the stance of the standard setting body towards the banking regulator might be described as ignoring their concerns, given the conviction that what mattered were financial investors. This view is expressed by a long-term member of the GASB, when asked about the interaction with the banking regulator at the time when the GASB fought for the introduction of SIC 12-like regulation:

“the contemporaneous BaFin, as this is today a part of BaFin, so the regulators we have never cared about, never interacted, we didn’t care about them“ (interview Berlin, 12/06/2010)

The orientation was towards London and the IASC¹³⁶, with the domestic financial regulator not being perceived as an important stakeholder.

An additional problem to the introduction of the requirement of consolidation without a capital link was the way the 7th EC directive had been implemented in German law, which had chosen the mainstream option of requesting a capital link for consolidation. Until this was not removed, not much progress could be made, as the German standards setter acknowledged in an internal memo in 2002 (interview German standards setter 05/03/2011). Nonetheless, the private standard setter continued to push for a change in the consolidation rule according to SIC 12 from 2002 onwards¹³⁷, a push which was bolstered by the adjustment of the 7th directive by the EC in 2003 (*Directive 2003/51/EC*). After criticizing insufficient reforms of 2003 and 2004 on this aspect, the reform efforts of the DRSC culminated in the proposal for the modernization of the code of commerce in May 2005. In it, the DRSC assembled all desired changes to the accounting rules for consolidated financial statements, including the convergence towards SIC 12. This is the moment, when the long expected process for modernizing the German accounting rules officially started (s. Biener 2000: 63), but this initiative did not have much success either, as industry associations were blocking these proposals in the reform.

The process of accounting standards modernization announced in 2002 was to be completed only seven years later, in 2009, a delay partially caused by the lack of financing

¹³⁶ This orientation was supported by the fact that some of the technical staffs of the DRSC worked at the IASC before (such as the current president of the GASB, who was the technical director at the IASC from 1995-1999).

¹³⁷ The president of the Standard setter warned in 2002 in the prestigious *Börsenzeitung* of the dangers of hidden Enron’s in Germany, which required a modernization, s. Havermann 2002.

provided to this initiative¹³⁸. Neither in the first, nor in the second draft of the proposed reform bill was there any convergence towards SIC 12, result of a forceful opposition to such changes which began even before the first draft of the modernization law was written. The responsible official of the ministry of justice, attended conferences of industry bodies to announce the direction of the work (as is documented in a transcript of a speech of him in 2000, s. Ernst 2000: 48) and sought to tease out points of industry resistance in these dialogues. The general direction towards convergence with International Accounting Standards was clear, but the question was which points of convergence were too contentious or would provoke too much harm if introduced. An auditor delegated into the Ministry of Justice via the German Accounting Standards Board to help with the completion of the Modernization Act reflects why a rule similar to SIC 12 was not in the first draft of 2007:

“That was not yet inside of the first draft, there was a lot of thinking, back and forth, one could introduce it, but also there already there were interest groups saying, nonsense, we don’t need that, then we have to suddenly consolidate our SPEs. That was especially the association of Sparkassen and credit unions, let that be, we don’t do IFRS, so we don’t need that. And these are very powerful groups, as you can imagine. ... that was discussed before, but there was fear ... to meet resistance. You imagine law making probably in the wrong way, it is no longer we do it like that top down, bottom up... today there is a form of anticipatory obedience, with respect to the desires of lobbyists (interview Berlin, 05/30/2011)

The lobby groups most opposed to this change mentioned by him were the association of public banks and credit unions and the leasing industry.¹³⁹ The latter was explicitly stating that its “raison d’être” was threatened by these accounting rule changes, an argument which for industrial policy reasons was accepted. Asked how these lobbyists communicated their preferences, the auditor explained:

¹³⁸ In the process of reform, German auditing networks provided the ministry of justice with an auditor to be paid by the GASB, in order to quicken the process. This auditor stated that he was the only full-time employee working on the reform, in conjunction with the division manager.

¹³⁹ A banking manager from a large private bank, involved in the lobbying process also pointed to the public banks as the main lobbying force (interview Frankfurt/Main 07/12/2011).

“the ministry is “travelling” already before, it is invited to all possible meetings, gives a presentation there, and you state what is the direction and there you get feedback, and there you speak with important people who say that is good and this, we think is shit, this is said immediately... then one has an impression and given this impression in the background you talk again about these regulations, and then you come to the conclusion, special purpose entities, we better don’t push for convergence there, there are strong headwinds”

Asked about how such headwinds would express themselves, he pointed to articles in the relevant journals by academics, which he viewed as rather biased, statements by associations, but most importantly he referred to the link between these associations and the politicians in parliament:

“And then they (the associations, M.T.) goad their politicians, that means that you know from the beginning, that if it enters into the governmental draft and the legislative process, it will be destroyed. Because the decision makers in the end are the politicians, and then it doesn’t make any sense anymore to continue with the topic”

This statement implies that the inclusion of democratic representatives in the process of accounting rule modernization in a corporatist economy such as Germany, hinders, rather than helps the development of better accounting standards, if these contradict the interests of the most powerful industry associations. In addition, the topic of consolidated financial statements is so arcane, that politicians quickly lose sight of the actual effects of legislation (interview auditor, 02/21/2011). The gullibility of German politicians regarding the topic of off-balance sheet financing was additionally supported by the importance of the off-balance sheet technique for German small and medium sized enterprises. Referring to this fact, a regulatory advisor stated:

“that has to be said, in fairness, that you can discuss with politicians if you have hard numbers... that has to do with the fact that we have 80% credit finance and 20% capital market finance” (interview Frankfurt/Main 06/14/2011)

Off-balance sheet financing was seen as a way to reduce the dependence of the SME sector on banks and to increase access to the capital market for German corporations. In this respect, the extent and the importance of off-balance sheet techniques such as leasing for German SMEs can hardly be overestimated (the estimated volume of leasing contracts in 2009 stood at a total of Euro 250 billion, s. Cervený et al 2010: 12).¹⁴⁰ In addition, much leasing and factoring itself was itself financed via Asset-Backed Commercial Paper, forming a very specific German bank-based shadow banking system directed at the financing of SMEs which would not lead to a deterioration of their balance sheets (s. Cervený et al 2010: 35f)

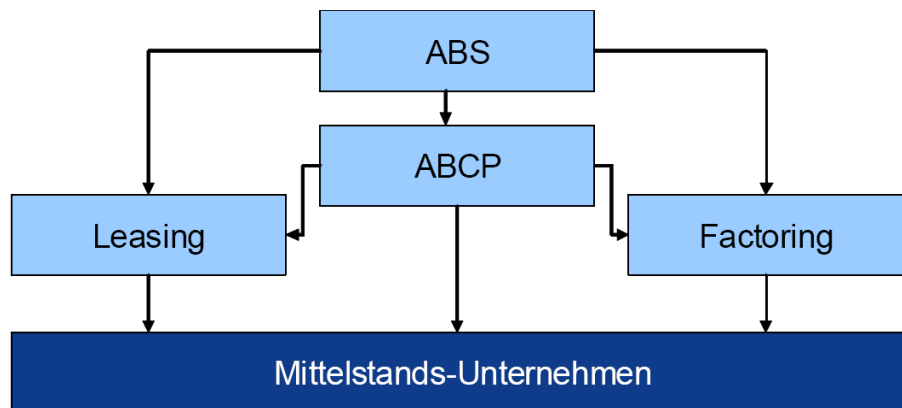


Figure 19: German off-balance sheet financing circuit for SMEs
(Cervený et al 2010: 35)

This circuit of financing involved the banking conglomerates as sponsors of leasing vehicles (s. Hartmann Wendels 2003) and ABCP conduits, the small and medium sized enterprises as well as large enterprises which also used leasing, a formidable political alliance seeking to inhibit any changes to the accounting rules which could impact their business. The fervour of this alliance

¹⁴⁰ Most of these leasing contracts were not registered on the balance sheets of those taking the lease, nor of those granting the leases, but instead were placed in leasing object societies, SPEs which were orphaned and thus had the quality of stand-alone entities. A change to the accounting rules which required consolidation of these SPE's would lead to the appearance of these leases as liabilities on the balance sheet of SMEs who took the leases or on the balance sheet of banking conglomerates which were central on the supply side of leases, which unified corporations and banking conglomerates in their opposition to rule changes. Most leasing corporations are subsidiaries of banks and savings association. In 2001 these subsidiaries financed 62% of the entire leasing volume (s. Hartmann-Wendels 2003).

was strengthened by another characteristic of the German banking system, German Sparkassen and Raiffeisenbanken are not listed on stock markets nor are they emitting bonds. For this reason, domestic rather than international standards were to remain their accounting framework, which led these groups to be invested in blocking certain reforms which would force them to consolidate prior unconsolidated SPEs (interview auditor who was involved in drafting the modernization law of accounting standards, 05/30/2011).

This financing complex, involving a variety of off-balance sheet financing instruments was supported by the ministry of finance.¹⁴¹ SPEs were appreciated as central for ABCP-programs and for leasing programs which kept tens of billions off the balance sheet of German firms and the German state sought to provide a regulatory environment which would allow its domestic banks to provide these services with domestic SPEs, seeking to support the domestic industry and the financial sector at the same time (s. the statement of the German state secretary of the finance ministry Asmussen, 2006). A Boston Consulting Group study was commissioned by the ministry of finance to detect all obstacles to such financing (s. BCG 2004). The obstacles identified were removed in the following years, with the creation of a register which allowed the sale of debt to another financial investor without informing the debtor, or the exemption of a tax on commerce for SPEs realized in an act for the promotion of small enterprises (Kleinunternehmerfoerderungsgesetz) in July 2003. This initiative for domestic securitization also implied that the banking regulator BaFin would support securitization, as it is subordinated to the German finance ministry where the Ministry of Finance has the right to direct the behaviour of the BaFin and to revoke its decisions (“Weisungsrecht”). Any move to counter this pro-securitization stance, such as clamouring for accounting standards that could lead to the

¹⁴¹ The Finance Ministry was engaged since 2003 in a campaign to support domestic ABCP programs to finance the German “Mittelstand” (small and medium sized enterprises).

consolidation of SPEs on balance sheets and thus to the application of core capital requirements was certain to meet the opposition of the ministry of finance, which made action on the side of the BaFin look futile.

Official BaFin: as far as I know this was an issue for the ministry of finance (the promotion of securitization in Germany, M.T) that wanted to strengthen the finance place Germany, that has been quite futile, the BmF has the control of legality and supervisory control, so in principle they can tell us what to do, and when there was such an initiative it is quite evident, that this is favoured (interview Bonn 07/01/2011).

The importance of SMEs to the German economy and the importance of leasing to that sector explain much of the preference formation in the policy network. The procedures of standard setting in Germany then allowed these preferences to block convergence, until the cataclysmic event of the financial crisis brought about a change of position.

After completing the first draft (Referentenentwurf), the document was sent to all large industry associations and the responsible ministries for comments. In this comment period, the banking associations (private as well as public) and the leasing associations, as well as others applauded the fact that there was no convergence of German rules with SIC 12, and they made clear that they would oppose any change in this direction (interview auditor involved in drafting the law, Berlin 05/30/2011). The draft did not include any such measure, as industry opposition signalled already before that convergence to SIC 12 would face stiff opposition. Given the political support of these large associations, the chances for convergence seemed so small that it wasn't deemed worthy even to try.¹⁴² In the first and second draft of the law for the modernization of the code of commerce, in November 2007 and October 2008, no changes to the criteria for consolidation were envisaged. Only in the aftermath of the crisis, in 2009, due to the magnitude

¹⁴² Other innovative measures of international accounting, such as the cash generating unit, were included in the first draft, testing their acceptance and after these faced opposition by association as well as in the expert press, also these measures were dropped.

of the shock caused by the financial crisis in general, and ABCP conduits in particular, did the ministry of justice agree to converge the rules for consolidation with those of SIC 12. This move came as a total surprise to the banking industry (interview senior management large German bank, Frankfurt 12.07.2011). Without the crisis these changes would have never happened due to the resistance of large industry associations, as the auditor involved in writing the law confirmed:

“This whole SPE-story is last minute, it is not in the first draft, not in the government draft, then there was suddenly this implosion in the capital markets, and then there was this advance suddenly from all possible sides, from the auditors I mean, the standards setting body, smaller auditors association and from the IDW, primarily from the IDW, and as these SPE from this small bank, the Sachsen LB and the IKB imploded, every politician realized this risk is real and can threaten the existence, and so suddenly a slot is open, a time window, I can make a regulation which otherwise would not be possible, the banks, so the Sachsen LB always said, no, we don't want that, but now they didn't have a choice” (interview, Berlin 30.05.2011).

The delay was the success of an economically and politically entrenched opposition and a splintered framework for accounting rule setting, where there were many points at which proposed changes could be vetoed. It took significantly longer for German accounting norms to converge to international standards compared with France, Netherlands or Spain. The more successful resistance to more stringent accounting rules with respect to off-balance sheet financing has several reasons. One reason is that in contrast to Spain or France, there has never been a separate accounting regime for banks. In Germany, a single set of accounting rules applies to all firms, which means that changes to the rules for consolidation, and thus for off-balance sheet financing faced opposition from all groups engaged in off-balance sheet financing at the same time¹⁴³ The coalition for reform was also remarkably weaker than in France. The German banking regulator remained largely absent in this process of policy formation due to its subordination to the ministry of finance and its lack of formal integration in the standard setting process. The transformation of the policy network in response to the transnational pressure,

¹⁴³ In contrast to France, where this reform process unfolded in a two-step process.

instead of including them in it according to §342b (an option favoured by the regulators at BaFin I interviewed, interview Bonn, 07/01/2011), created an emasculated private standard setting body. This “façade” institution, whose domestic position from the beginning was heavily circumscribed, didn’t have any power to overcome the domestic opposition to these changes.

A completely different story emerges from the Spanish case, where the banking regulator successfully opposed transnational pressures for ceding its standard setting power over banking conglomerates, but on the other hand brought about convergence with IAS standards for the scope of consolidation.

5.4.4 Spain

In contrast to all these changes, brought about by European directives seeking harmonization of the accounting regime for banks with the general accounting regime (EC 86/635) and the ascendancy of the IASC to international prominence, in Spain, the banking regulator never ceded the power over accounting regulations for its banks. After the painful experience of the banking crisis which ensued after the fall of Franco (1977-1983), based on fraudulent accounting schemes, the Bank of Spain was given the combined power of prudential regulation, supervision and accounting standards with the “Ley de Organos Rectores del Banco de Espana” in 1980 (s. Ramos-Tallada 2010: 60). Given how recent the crisis and this decision was, the Spanish polity refused to undo it due to a European trend for centralization of accounting standards, which was not being mandated by any legislation. Therefore, when the International Accounting Standards (and with it SIC 12) are introduced as the accounting framework for conglomerates in general (starting from January 2005, the banking regulator is responsible for the translation/ adaptation of the rule for banking conglomerates (Circular 04/2004 of the Banco de Espana) as well as its application for core capital requirements (Circular

3/2005 of the Banco de Espana), leading to the most stringent application of SIC 12 for banking conglomerates in the four cases.

The Spanish banking regulator did not issue any modernized accounting rules for consolidation between its first rule in 1991 (Circular 4/1991 of the Banco de Espana) up until end of 2004. Given that the attainment of off-balance sheet status was rather sparsely defined, it was rather easy for Spanish banks to reach off-balance sheet status (s. Ramos-Tallada 2010: 61f). The Bank of Spain used the window of opportunity in 2004. In the Directive 2003/51/EC of the European Parliament that permitted countries to require consolidation of SPE's even without a capital link between them and their sponsoring banks and in 2005, according to EU law all conglomerates listed on European stock markets had to shift towards IFRS. In this moment, the Banco de Espana updated its accounting standards for consolidation for banking conglomerates in such a way that achieving off-balance sheet status for ABCP conduits was made almost impossible.

In the run up to that decision, banks had approached the Banco de Espana and requested permission to set-up securities arbitrage conduits. However, the regulator, who was already concerned with the extensive growth of mortgage credit in the economy, refused to allow this innovation (Tett, 2008, Macuchan 2011: 504f).¹⁴⁴ Instead it was “gold plating” SIC 12 in a way that was answering to the problem of stitching on the edge by installing the principle of prudence in the principles based decision making of auditors, to specify the grey zone that structurers seek to enter into as a zone in which the principle of prudence prevails. Auditors were explicitly asked to err on the side of prudence in uncertain situations. The decisive document is the circular 4 of the Banco de Espana issued in 2004. This went beyond the treatment for securitization in the

¹⁴⁴ Spanish banks were enjoying particularly strong profits in the decade before the crisis (almost quadrupling in absolute terms from 1999 to 2007 (s. OECD 2008), which reduced the pressure on the regulator to concede to the demands of banks.

new Basel 2 framework. Rather than simply applying the securitization framework of “significant and substantial risk transfer” which had to be achieved for the de-recognition of assets, the Banco de Espagne took into account the balance sheet of the Financial Holding Company in its entirety, including SPEs.

In consolidated financial statements, the criteria set out in the above paragraphs for de-recognizing financial assets shall be applied after fully consolidating all the subsidiaries. In particular, the circumstances referred to in paragraph 1.b) may arise in transfers to special purpose entities defined in paragraph 5 of Rule forty-six fully consolidated in the group, such as securitisation special purpose vehicles” (Banco de Espana 2004: 55).

In addition, they added a third category to the decision tree of the auditor which applies when “the risks and rewards associated with ownership of the asset are neither transferred nor retained substantially “. In this case the accountant is asked to focus on the cash flows as well as the capacity of the SPE to sell the assets without the consent of the sponsor (Ybanez and Garcia-Fuertes 2005). Only if the SPE can do so on its own shall it not be assigned to the bank sponsor. This last requirement clearly contradicts the construction of an SPE, in which the bank wants to maintain the control over assets, while legally transferring them. Finally, if there are doubts on the part of the auditor, s/he is requested to err on the side of consolidation.

“When it is difficult to conclude whether the risks and rewards of the financial assets have been transferred substantially or significantly, or when the various elements of analysis considered individually indicate that the risks have been transferred, but considered together do not permit that conclusion so readily, the transfer shall be classified as one in which the risks and rewards have been retained substantially.” (Banco de Espana 2004: 52)

Translating SIC 12 in this way, the orphaning of special purpose entities becomes almost impossible, forcing them instead on the balance sheet of the sponsoring banks. As a result, from 2004 when the overall volume of ABCP conduits grew strongly (Figure 1) Spanish banks were

de facto regulated out of the market for all securitizations (Tett, 2008, Thiemann 2011). The Spanish regulator thus acted forcefully to prevent the build-up of off-balance sheet vehicles by forcing SPE's into the perimeter of accounting and of prudential regulation.

5.5 Conclusion

This chapter traced the de-institutionalization and re-institutionalization of the role of the banking regulator in accounting standard setting in national frameworks. When we compare the risk regulation regimes for ABCP conduits in these four countries with these movements of de- and re-institutionalizations, it becomes evident that there is a high linkage between the inclusion of the banking regulator in the policy networks and the use of SIC 12-like rules for banking regulation (s. table 5-1 below).

Countries/categories	Germany	Netherlands	France	Spain
Legal structure: Which institutions have what kind of legislative power, where are entry and veto points?	Finance ministry and ministry of justice work together to renew the commercial law relevant for accounting, the accounting standard setter can propose issues, the lobby groups are very powerful early on in the reformulation process and have high influence on the finance ministry. Little transparency and little power for regulator, veto points at the ministry of justice for lobbies.	Accounting standard setter can issue non-binding standards. Ministry of Justice revises its rule book in reforms, but these are much fewer than accounting standards by the standards setting body. Veto points: The employers' association has large influence on the law making process (interview AFM 10/06/2011), in the standards setter the preparers are powerful.	Commission bancaire is involved in modernizing the accounting law in the CNC, which is also linked with the finance ministry. Fight between regulators and finance ministry in cnc. Entry points in finance ministry and in cnc. Veto points rare, rather retribution	The Central Bank is since 1988 the accounting standards setter for banks. In dialogue with its banks it develops the accounting standards. It is also a member of the general accounting standards setter (s. http://www.icac.meh.es/ICAC/QuienesSomos/Quienes_Somos.aspx)
Are standards legally binding?	Yes	No (only those inserted into Dutch Commercial Law)	Yes	Yes
Sensitivity to political and interest group demands in the standards setting process	High (at the ministry of justice)	High (preparers and auditors predominate the standards setter, interview Dutch Auditors association,	Less so, due to direct confrontation with CB, however in 2004	Low

		07/05/2011), but mitigated due to lack of relevance of standards	CNC used by banks and ministry of finance to push through more lenient rules	
Nature and development of the ABCP market	Rather late due to high legal uncertainty from 1995 to 2003, governmental push for the development from 2003	Early (from 1995 onwards), big market, high securitization domestically and from assets abroad	Since the late 80s, enshrined in laws regarding SPE (FCC) in 1988, early push by government, then very concise attempts of banking regulator to fine-tune business	Very early development of securitization, but very late, very small development of ABCP market, only one ABCP conduit since 1998 (Banco Santander, Moodys Program Index)
Collaboration of prudential regulator and standard setter	No	No (yes, until 1993)	Yes	Prudential regulator is the standard setter
Changes of the governance architecture due to transnational isomorphic pressure	Creation of a private standard setting council, with very limited capability, reason for creation is outward oriented	Dutch Central Bank is expelled from governance architecture due to complete emulation of goals of the IASC	Reform of 1996 and 1998 centralize standard setting in CNC, but CB is included	No changes
Use of consolidated SPEs for core capital requirements	No	No	Yes, until 2005, after that even stricter standards (s. next chapter	Use of consolidated SPEs for core capital requirements

Table 5.1: Standard setting in the in the four countries

Transnational isomorphic pressures were common to all the four cases investigated, accounting rules were deemed as unfit and the way of setting accounting standards deemed as outdated in all of them. The reaction to these pressures was markedly different as this chapter has shown. If banking regulators obtained or preserved a role in standard setting, their inclusion in the policy network meant the installation of a force pushing for prudent accounting standards (this finding also holds for the Portuguese case in the positive and the Belgian in the negative).¹⁴⁵

The rule investigated here, SIC 12, which is principles based and puts economic substance over legal form is challenging to all continental-European Accounting standards systems, but the

¹⁴⁵ In the case of the delimitation of conglomerates, prudence implied the push for the consolidation of all corporations on the balance sheet of the conglomerate, if the majority of risk and rewards of the business of these corporations was borne by the conglomerate.

Dutch one. As the difference between France and Spain on the one hand and Germany on the other shows, it is not accounting tradition per se, which can account for convergence or the lack thereof, but how this tradition is shaped and transformed by the actors in the policy network. Transnational developments disrupt national regulatory frameworks, but they also offer opportunities to install regulatory regimes which are more favourable for prudence. How regulatory agencies adapt to these changing circumstances is decisive. They can manoeuvre to gain a central place in the new configuration and appropriate the rules that emerge from a transnational context they deem appropriate, as in the French case. Institutional tool-kits and traditions can play a supportive role in this quest, evidenced by the fact that the French banking regulator could arrange its inclusion in French Accounting Standards Setting based upon the collegial style of standard setting which prevailed there. Such a culture was not present in the Netherlands or Germany. On the other hand, the complete convergence of the Dutch Accounting Standard Setter in his goals towards the IASC, installing a completely different due process which is more exclusive of stakeholders of accounting standards led to the permanent de-institutionalization of the Dutch Central bank in standard setting. This fact points to the due process in particular as an important element for the de- and re-institutionalization of the banking regulator.

There is a certain degree of path dependency in the role of the banking regulator in accounting standard setting and the evolution of the regulatory treatment of SPEs, as the implementation of the 7th directive for banking conglomerates shows. An independent accounting regime for banks and the thoughtful implementation of the 7th directive for banks in the 80s in France proved beneficial a decade after it was enacted, permitting the regulator to adapt the accounting rules to new constructs of regulatory arbitrage. In contrast, changing

German accounting rules for banks was harder to achieve as rule changes automatically applied to all conglomerates, and the implementation of the 7th directive made consolidation without a capital link impossible until 2003. Furthermore, there was no tradition of involvement for the banking regulator in the accounting standard setting process. These different paths taken in the interaction with external directives, shaped or not by the intervention of banking regulators impacted the timing of the convergence to SIC 12-like rules and the use of the accounting information for core capital requirements. It appears as a self-reinforcing process, in which banking regulators at the heart of the accounting standard setting regime take decisions today, which will be beneficial for their regulatory action in the future. Such good decision-making is possible due to their position in the network issuing accounting standards, but it does not automatically follow from that position.

Instead, what informs this decision making is the supervision of actual developments in accounting, the monitoring of the interpretation of accounting standards and the enforcement of accounting decisions. Only by being within the field of accounting for banking conglomerates can banking regulators make good decisions. As we will see in chapter six, this embeddedness was a crucial factor in the pro-active stance of the French regulator. It also had a direct impact on how effective the newly introduced standards could be. Given that SIC 12 and its translations are a principles-based accounting rule, the restriction thus imposed on banks could only be as good as the interpretation of the rule (s. the discussion in the last chapter). The differential build-up in the off-balance sheet position in the ABCP-segment in the different countries cannot be explained by these rule changes alone (nota bene, the early introduction in the Netherlands). Pushing the interpretation of SIC 12 towards prudence was another task that differentiated the French and Spanish banking regulators from their Dutch and German counterparts. In the

following chapter, I will investigate the governance networks in my four cases concerning the supervision of accounting decisions, the differential embeddedness of banking regulators in it and the effects these different constellations had upon the application of SIC 12 and its counterparts in domestic GAAP.

Chapter 6: STEERING FINANCE TOWARDS PRUDENCE – THE ROLE OF BANKING REGULATORS IN THE GOVERNANCE OF ACCOUNTING DECISIONS

“From my point of view, what is important is not to have anymore special purpose entities to be orphaned, wherever they end up, they should not be nowhere ... So I would say, if you have to err, you should err on the side of prudence. (interview with employee of the banking federation, France, Paris, 05/11/2011, translation M.T.¹⁴⁶).

6. 1 Introduction

In the last chapter we have focused on how transnational impulses reconfigured the role of banking regulators in accounting standard setting and shaped the space of manoeuvre for them to bring about the introduction of SIC 12-like rule. In this chapter, we will shift the focus to the domestic governance network controlling the application of these rules. The comparison of the different capabilities and capacities of banking regulators in the field of accounting supervision allows me to answer the question why the Spanish and the French banking regulators became involved with the introduction of SIC 12-like rules in the first place, while the German and the Dutch one didn't. The comparison will furthermore show that the efficiency of the SIC 12-like rules to force ABCP conduits on the balance sheets of their banking sponsors depended on the steering of the interpretation of these rules into an encompassing direction, including all the risks and rewards emanating from these entities, to force auditors “to err on the side of prudence”. Steering the application of SIC 12 into a prudent direction meant to expand the events, risks and rewards which needed to be taken into account and thereby to sharpen the criteria which an SPE has to fulfil to be assigned the status of a stand-alone, independent corporation in accounting terms. As will be seen below, banking regulators could play a central role in pushing for a stricter interpretation of accounting standards.

¹⁴⁶ «Donc je dirais que si on doit se tromper, mieux vaut se tromper dans le sens de la prudence. ... A mes yeux, l'important c'est de ne pas avoir des entités ad hoc orphelines, n'importe où, ils ne doivent pas être nulle part. »

In my analysis I rely on the concept of the “risk regulation regime” (developed by Hood et al 2001) to analyze the differential capacity of banking regulators to evaluate the risks emanating from ABCP conduits and to shape the interpretation of accounting standards. The concept was developed to investigate the variation of regulatory capacities containing risks across countries. Risk regulation regimes are defined as “the complex of institutional geography, rules, practices, and animating ideas that are associated with the regulation of a particular risk or hazard” (2001:9). Risk regulation regimes are conceptualized as systems, of three interrelated components, information gathering (monitoring), standard-setting and the enforcement of these standards. In order to understand the functioning of such a regulatory regime one needs to analyze the interactions of its different components, which makes it necessary for the researcher to be “interested just as much in what ‘street bureaucrats’ and front-line people do on the ground as in the activity of standard setters and policy makers at the centre of government and in the relationship, if any, between the two.” (Hood et al 2001:9). The analytical emphasis is on the translation of the perception of problems in the application of rules into standard setting and enforcement action. I have sought to illustrate this dynamic for the case of accounting standards in the figure below.

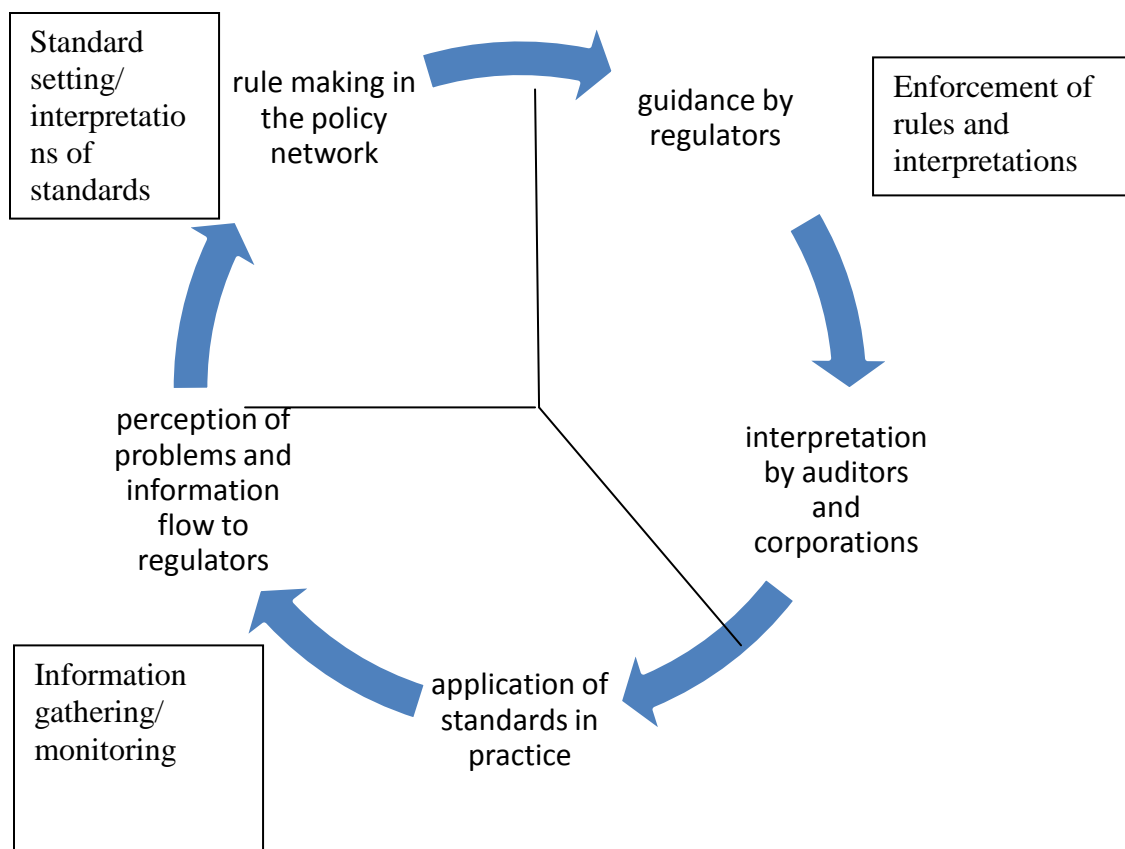


Figure 20: Regulatory regimes in Accounting

The observation of the professor of accounting on the development of rules for off-balance sheet financing, quoted in chapter 3, gives us a notion of this ever-continuing circle of accounting rule setting depicted in figure 20.

So the companies want to find a way to keep financing off-balance sheet. So the banks find vehicles, the world becomes aware of that. **The auditors tell the standards setters that they are not happy about this and the standards setters issues a rule about this saying you cant do that or if you do that, this happens. So then they go away and start the game again, so alright, if we cant do that anymore, let us find a new way of doing it, so it is an ongoing thing.** ... because they test the rules to destruction, they destroy the rules and the rules have to be remade. (interview in Paris 03/03/2011)

In the case of principles based accounting standards, this circle of creation and destruction of standards shifts from the level of standards itself to their interpretation. In

principles based standards, the exact meaning of the standard is often left deliberately open in order to avoid regulatory arbitrage via structuring activities (what was called “stitching on the edge” in chapter 3). This means, at the same time, that much of the actual interpretation is developed in the negotiation between auditors and audited. In the process, interpretations can develop which counter the initial goal of the standard as envisioned by the standard setter. The reaction to creative compliance then does not only involve the issuance of new standards, but also the installation of new interpretations of existing standards (as indicated in figure 18). Once dissatisfactory interpretations are identified, the standard setter and other regulators can intervene and engage auditors in regulatory dialogues in order to rectify these deficiencies¹⁴⁷. But in order for this intervention to occur, regulators first need to be able to monitor the developing interpretation, which requires the co-optation of external auditors.

6.2 Regulatory dialogues: the fight over the implementation of SIC 12

Governance theory emphasizes varying governability of different sectors in the economy in different countries, depending on the capacity of state agencies to involve private actors in the implementation of rules (Mayntz 2009: 21). Non-state actors are seen as more powerful in shaping the implementation of new rules the larger their tacit knowledge (s. Mayntz 2009). In order to reduce this power advantage of private actors in accounting, regulators need to gather information about the way accounting rules are currently interpreted and how future rules might be interpreted. In such a situation, regulators need to strengthen their ties with the external auditors, engaging in frequent (informal) dialogues with them in order to stay abreast of the most recent contractual innovations in accounting.

¹⁴⁷ In the case of SIC 12, one important question is how the notion of the majority of risks and rewards should be interpreted. Which events, which risks and rewards should be included and which can be excluded. Certain events need to be excluded in order to make the entire calculation possible, however, the question is which events.

This need for dialogue especially holds for principles based accounting standards emphasizing economic substance over legal form. Accounting and banking regulators often favour an economic substance approach,¹⁴⁸ as a principles based analysis of economic substance hinders the structuring work of lawyers and regulatory advisors (a process called “stitching on the edge” in chapter 4). The uncertainty for those engaging in “creative accounting” that is generated by principles based accounting standards, however, carries a disadvantage for the regulators regarding their capacity to control the accounting process itself. Because much of the decision-making in this system is delegated to local accountants, the system’s effectiveness in achieving the desired high end-goals depends on the interpretation of these principles in the community of accountants, internal and external to the firm. The fact that so much discretion is granted in interpreting the rules makes the implementation of principles at least as relevant as their exact wording (ibid: 31). The delegation of much of the actual interpretation of the rules to those applying it carries the possibility of a very lax, permissive interpretation of these rules. Therefore, regulators dealing with principles based accounting standards need to follow a strategy of compliance which involves “negotiation, advice, education and compromise with the regulated” by the rule-maker to achieve effective regulation (Black 1997: 29). This fact makes a constant conversation between regulated and regulator necessary in order to achieve the appropriate application of the rules. As an answer to the problem of how to achieve the desired shared interpretations of general principles, legal scholars have proposed the development of interpretive communities which together define the content of these provisions¹⁴⁹, characterized

¹⁴⁸ A simple example regards the question of legally enforceable debts a company has given to another company. If the other company is nearing bankruptcy, the economic value of that asset is lower than is predicated by the legal form. Economic substance thus aims at taking into account the economic circumstances which surround the contracts.

¹⁴⁹ “Certainty in a principles based regulation has less to do with how a particular provision is drafted and more to do with the development of an interpretive community that defines the content of that provision” (Ford 2010: 31).

by iterative regulatory dialogues between regulator and regulated (Black 2002). There has to be a “dense network of ‘regulatory conversations’: dialogic, iterative and reflexive communications between regulator, regulatee and others as to the purpose and application of the principle.” (s. Black 2008: 17). These regulatory dialogues should achieve certainty by establishing interpretive communities, a certainty which otherwise is provided by clear rules.

“Interpretive communities are a way that mutuality of interpretation could be assumed without further specification by rule. What is necessary then is that the rule maker, the regulated and enforcer share those norms, values, goals that give rise to a shared understanding as to the rule’s meaning and application.”(Black 1997:33)¹⁵⁰

In the case of SIC 12, the interpretation of the principles based regulation is polycentric, with the negotiation between auditors and audited being at least as important as the dialogue between auditors and the regulators.¹⁵¹ In polycentric interpretive communities, there can be different understandings at the regulator and at the regulated and advisors (Black 2008: 25), which increases the necessity of an on-going regulatory dialogue between the regulator and the regulated. The requirements for principles based standards to work, especially in poly-centric networks make it very prone to failure and require a delicate intervention of the state in the form of the regulator in the system. It requires the regulator to have “necessary capacity in terms of numbers, access to information and expertise” (Ford 2010: 8), which provides the regulator with a strong voice steering the interpretation of principles (ibid: 40). Regulators must be able to independently scrutinize information in order to see if the front-line decision makers have

¹⁵⁰ In a similar vein, Ford concludes, “Fundamental to principles based regulation is the development of a functional and effective “interpretive community” that includes industry participants, regulators and other stakeholders in ongoing communication around the content of regulatory principles.” (Ford 2010: 5)

¹⁵¹ Black differentiates different regulatory regimes coupled with principles-based regulation. There is the formal variant, in which principles are only found in the rule book, but are accompanied by very strict guidance. There is the substantive one, where rules are applied in a flexible and principles driven way and then there is principles based regulation based on polycentric networks, where a range of actors develops the interpretation of principles, including non-state actors that produce guidance. Consultants and voluntarily appointed advisors play a key role in shaping the application of Principles based regulation (Black 2008: 24).

interpreted the rules as desired. Their capacity to do so is enhanced if regulators themselves engage in probing the accounting decisions taken by the audited (s. Ford 2010). These different requirements clarify that the implementation of principles based regulation imposes high institutional demands on regulators and cannot be left to the integrity of external auditors alone.

While auditors are legally liable for the correctness of the accounting statements they certify, this liability resides in a broad space of legally defensible decisions. The client-customer relation pushes the interpretation in this space in favour of the corporation, with the help of pressures exerted by regulatory advisors, lawyers and corporations detailed in the third chapter. Auditing networks seek to counter this tendency by installing technical departments which review the legality of the accounting decisions of the business partners of the auditing network.¹⁵² But even these technical departments have limited capacities to suppress the manipulation of financial statements through financial innovations, as the burden of proof regarding the conformity of accounting decisions with the accounting standards resides with the auditing firm. If auditors cannot find evidence that the decisions of the internal accountants contradict these principles, they have to accept it, leaving them only with the possibility to issue a dissenting point of view in the financial statement.

In order to provide external auditors with the capacity to constrain the misuse of these innovations, accounting standards need to be expanded or an interpretation needs to be issued by an authority over accounting standards (either auditors' association, standard setting body, financial regulator or banking regulator) that directly reacts to these innovations and signals to external auditors and internal accountants alike that this innovation is no longer receiving the

¹⁵² Interview former IASB member January 2011, and member of dutch accounting supervisor October

benefit of the doubt¹⁵³. This intervention requires the capacity to monitor developments and the capacity to steer auditors and audited in their decision making through the power of sanctions.

The Netherlands, which will be discussed as the first case, clearly demonstrates that monitoring alone will have only little effect, if regulators cannot intervene upon such knowledge and that principles based standards without such intervention are prone to failure. It also demonstrates as a negative case the need for the dialogue among the different regulators concerned with and impacted by the application of accounting standards and with the auditors to ensure their proper application.

6.2.1 Netherlands

Before the introduction of SIC 12 into Dutch GAAP, there already was a group concept (issued in 1990), which requested the consolidation of entities under common control onto the balance sheet of the conglomerate, even without a capital link. Its fate presaged the effect of the translated SIC 12 on Dutch Accounting, revealing the impact lack of enforcement can have on a principles based standard. It was one of the last big independent innovations of the Dutch Accounting Standard Setter regarding consolidated financial statements, whose creation was pushed for by the Dutch Central Bank seeking as much disclosure as possible regarding its large banking conglomerates which were merging with large insurance companies (s. van Lent 1997, esp. p. 23). The group concept incorporates an economic substance over legal form approach by specifying that if two corporations are controlled in substance by management, these two

¹⁵³ Early intervention in the development of these practices is important, as management will structure organizational relationships according to prevailing interpretations, constructs which to undo can be extremely costly. For example, if leasing contracts can be created which ensure the off-balance sheet status of certain debts for companies, this can lead to strong growth of these contracts, which is based only upon the accounting decision. The earlier accounting regulators intervene to stop this kind of behaviour; the lower will be the resistance of the regulated. On the other hand, if contracts worth billions of Euro are signed and entire business models are based on the provision of such contracts, it will be more and more difficult to change these interpretations.

corporations form a group and the corporation with the controlling management shall consolidate the other corporation in its balance sheet, even if it does not have a capital link (s. Book 2, Subsection 1, Section 406 Netherlands Civil Code¹⁵⁴). However, this group concept seemed to have little effect, as the indicators of groups were not clearly spelled out in the concept and so it was effectively ignored by most corporations and their auditors (interview Accounting Professor Netherlands, 06/16/2011, accounting professor 07/19/2011). It did not make much of a difference to actual Dutch Accounting, as there was neither concrete guidance nor enforcement, as a regulatory advisor explains:

V: “for the capital adequacy they were allowed to take capital relief because they got rid of the credit risk. And what happens I guess is that when the DNB allowed capital relief, well, then the guys, not seeing any rules in Dutch GAAP, said that well then it is fine for financial statements as well. ...

The quote above suggests that decisions by the DNB impact the views on and the decision making of auditors about ABCP conduits, even if there is no direct legal link between the decisions of the banking regulator and accounting standards. When having to evaluate a new product, for which rules are missing, auditors are looking in other regulatory systems to gain a grasp of the potential problems (background interview German enforcement agency for accounting decisions). This interrelatedness of banking and accounting regulatory decisions suggests that a direct dialogue between banking regulators and the accounting community over accounting rules is appropriate. The regulatory advisor continued:

it is pretty clear that a lot of the auditors did not understand these vehicles, at the beginning at least, ... so they saw a foundation, an SPV, they saw it being managed by a trust office, so they thought there was no control, the concept of autopilot didn't exist. **We had the group concept, but the group concepts didn't have the specifics of SIC 12 in it yet** and in that environment the banks could put pressure on ...
M: the banks put pressure on the auditor?

¹⁵⁴ Accessible at <http://www.dutchcivillaw.com/legislation/dcctitle2299bb.htm>

V: well it is not even pressure if you ask me the banks could do whatever they wanted. They wrote a paper or a proposal and there was not an auditor who could say here are the rules, there were no rules.” (interview 10/06/2011 Amsterdam)

The quote above shows that principles based accounting standards which have no clear criteria will produce worse results than rules based criteria if there is a lack of enforcement by the regulators. An ABCP conduit could be considered a member of the group, due to the common management, but for auditors to enforce this point of view against bankers upon new circumstances proves difficult. Bankers were exploiting the fact that there were no clear rules to follow, and the absence of direct guidance by regulators aggravated the problem. This situation did not change immediately with the introduction of SIC 12, as also there clear rules and regulatory supervision was missing.

Regulatory advisor: “and we put SIC 12 in Dutch GAAP, but some auditors claimed that it was not literally translated and they claimed that there were still possibilities to have these kinds of vehicles off-balance

M: who do I have to imagine now in the conversation about this decision, there is the bank, there is the SPV, there is the auditor from the Big 4, making the decisions and is there also a regulation person at the table

V: at that moment not” (interview Amsterdam 10/06/2011)

As regulators are not present to probe/ control the actual decision making between auditors and audited, auditing networks in collusion with their clients simply refused to accept the new standard as limiting their capacity to place these conduits off-balance sheet, even if, as an accounting professor pointed out to me, the Dutch standard is a direct translation of SIC 12 (06/16/2011). This act of disobedience was noticed, but went unpunished for two years. In reaction to this recalcitrant stance of several auditing networks in the Netherlands, the Dutch standard setter issued a footnote in the Dutch Accounting Standards book for the year 2003, which specified that it was indeed a direct translation. This misapplication of the Dutch

equivalent to SIC 12 by the auditing networks was detected by the Dutch Accounting Standard Setter due to their direct linkage with the auditing networks.

Regulatory advisor: “so in 2001 we got more firmly the rules in Dutch GAAP, so I am looking for an interesting remark in a footnote, ... because a large auditing network said, no, no; this is not a literal translation of SIC 12, they put it in, they said [in the footnote, M.T.] this is a literal translation of SIC 12. And then we knew that these vehicles, and we already knew that because the IFRS was coming in Europe, so we knew that these vehicles needed to be consolidated under IFRS. But also got a firm warning, listen guys, you need to consolidate this stuff.

M: from whom

V: from the raad vor de jaaresverslageving, because what they said with that footnote: listen guys, we understand that some of these are not consolidated, but bad luck guys, this is a literal translation of SIC 12.

This detection of the misapplication of SIC 12 was an outcome of the institutionalized linkages the standard setter entertained with the large auditing networks, as the regulatory advisor explains:

Regulatory advisor: But it was obvious for the standard setters, that parties, and not only X and Y, but also other parties, that they were not applying the rules as it should be, That is all based on a phone call whatever, I was not involved at that time, but am now, in meetings between the standard setter and the big four, I am the chairmen of the committee at the RJ, where also other audit firms are involved, most probably there was a debate in one of these committees and this debate was most likely brought to the board, to the RJ and then they adjusted the text. “

However, given the non-binding nature of the standards of the RJ and the fact that no other body was active at that time in intervening and correcting auditors' behaviour, this intervention did not alter behaviour immediately. The Dutch auditors association was not acting as an enforcement body of certain interpretations, as it is not issuing guidelines on how to apply/interpret accounting standards (interview Dutch auditors association, 07/05/2011). Therefore, the effect of this clarification was not an immediate increase in consolidation. Instead, there was a silent agreement between auditors and conglomerates to apply the new auditing standards in full force,

once the International Accounting Standards became binding, in 2005, and to not consolidate until then.

Regulatory advisor: “And then in practice, everyone looked forward to the IFRS implementation and in general not a lot happened in between. Everyone, how do you say that, it is typically Dutch to do that, you do something wrong but everybody allows it and everybody understands it.

M: so that was the situation between 2002 and 2004

V: yes, because in 2005 IFRS was applied and in those financial statements, all the banks; everyone did the right thing, so under IFRS, pretty clear, loads of debates, because then we started first, we allowed them not to consolidate against the rules for a while, because the rules were clear since 2001, but they were only there for three years, so we said don’t you worry for these three years, that is what more or less happened, and then as of 2005, the banks started to do structuring again”

These developments clarify the huge enforcement problem that existed in the Netherlands up until 2006, when the financial market regulator took over an enforcement role. It was very difficult to enforce standards which were seen as at the fringes, contradicted interests and habits at the same time. An accounting professor reported that in Dutch Accounting until 2005 most of the consolidation decisions remained linked to the legal concept of control, where control could not be exercised unless there was a capital link (interview 06/16/2011). As can be seen in this case, regulatory dialogues are a necessary condition for detecting the misapplication of principles based standards, however, they are not sufficient to alter behaviour. The regulator needs to have sanctioning power in the negotiation with the auditors, a sanctioning power absent in the Netherlands before 2006.

Regulatory advisor: “the dutch central bank did not have any accounting supervision role, they are only responsible for the ratio coverage **which are by the way build on accounting**. The dutch AFM¹⁵⁵, they started their accounting supervision 3 years ago, so at that time there was nobody else than your auditor who was judging if you applied the rules correctly or not.”

In the Netherlands, the Dutch Central bank, while relying on accounting information has no role

¹⁵⁵ Autoriteit for Financiel Markets, the SEC of the Netherlands

in any supervision of accounting decisions. While the central bank does have teams stationed in the large banks, these do not concern themselves with accounting questions, as the central bank is lacking the manpower and resources in the field of accounting (interview DNB 10/05/2011)¹⁵⁶. Instead, the DNB has outsourced many tasks related to prudential reporting entirely to the auditors,¹⁵⁷ instructing them what they should do additionally to their auditing work.¹⁵⁸ Due to these facts, the DNB could not detect any irregularities in the field of accounting. In addition, it also lacked any links to actors who did, as the institutional links between the Dutch accounting standard setter and the central bank had been severed in the early 1990s. This lack of active monitoring regarding the accounting decisions of their banks meant that when the DNB had to assess the risk of the new financial product of Asset Backed Commercial Papers and the related conduits, it was forming its opinion and decision making through conversations with bankers, corporate lawyers and with other regulators, most notably the FSA and the Fed (interview banking manager Amsterdam, 12/06/2011). In these conversations with corporate lawyers and “financial whizz kids” (ibid) the DNB was convinced to even drop a capital charge for the liquidity lines of less than one year, a fact which even surprised domestic banking managers (ibid). The DNB was lacking independent information and thus the capacity to challenge their presentations. Regulatory dialogues with auditing experts or the standards setter over problems related to the accounting for ABCP-conduits might have clarified to them the use of these vehicles as a technique of regulatory circumvention. Instead, they suffered from “cognitive

¹⁵⁶ These facts make the characterization of Dutch banking regulation as ‘light touch’ by a French banking regulator look appropriate (interview Paris 04/20/2011)

¹⁵⁷ This trend is reversing in recent years, with the DNB asking auditors to come in and explain recent market developments (interview regulatory advisor 10/06/2011)

¹⁵⁸ Any expansion of these duties meets fierce resistance by the auditors, as it is unpaid work (interview NIVRA 07/06/2011).

closure” due to their lack of critical sources in dialogues (s. Aalbers et al 2011: 1790¹⁵⁹). The lenient regulation furthered the development of Dutch banking groups as large sponsors of ABCP-conduits¹⁶⁰ and implied that the DNB was not interested in a careful application of a SIC 12 like rule once introduced.¹⁶¹

This lacking capacity for intervention was partially corrected when the financial markets regulator (AFM) got an enforcement role in 2006. But the way its powers were limited in the legislation establishing this task speaks to the power of the conglomerates in the Netherlands to structure their supervision. In order to reduce the costs of accounting for corporations, the Dutch parliament refused to grant the AFM the right for direct inquiry into accounting practices at the corporations, nor for any analysis that goes beyond published documents. Instead, the accounting division of the AFM can only act upon public information, and then can only request explanation and correction by the corporation. Sanctioning powers are only at the absolute end of possible means and can take years for enforcement (interview AFM 10/06/2011). In fact, the current law represents an institutional configuration which is severely limiting the power of the AFM to do its work.¹⁶² In contrast to this sparsely linked regulatory network which lacked the capacity to intervene in the decision making on the ground, the most significant example of regulatory collaboration to intervene in accounting practice in my sample can be found in the French regulatory network. There, the French banking regulator was a driving force behind these efforts

¹⁵⁹ Aalbers et al define this term as “ad hoc globalization”, informed by hegemonic views of finance in the US and the UK and the lack of alternative narratives communicated to or produced by the domestic regulator.

¹⁶⁰ ABN Amro, the largest banking conglomerate in the Netherlands was the largest sponsor of ABCP conduits and provider of liquidity facilities globally in 2007 (s. Fitch 2007).

¹⁶¹ This specific position by the Dutch Banking regulator on ABCP conduits was in line with the very supportive stance towards securitization in general, as its capacity on the one hand to enhance the credit supply enormously and on the other hand to provide securities of high quality to pension funds and investors was seen in a positive light (interview banking manager 12/06/2011).

¹⁶² For example, there are “Chinese walls” between the different departments in the AFM, such that the accounting division cannot share information with or ask the auditing division of the AFM for help, nor can they communicate concerning their cases with other state agencies such as the DNB. Their limited capacity to investigate corporate misconduct means that most problems of accounting practices cannot be detected in this way (interview AFM 10/07/2011) nor can the AFM ally with other regulatory agencies in order to intervene in accounting practice.

to sharpen the delimitation of the borders of their banking conglomerates. Close collaboration between the two regulatory agencies (the banking regulator CB and the financial market regulator, until 2003 COB, afterwards AMF) and the auditing networks (the technical departments in particular) lay the institutional foundation for a further tightening of the off-balance sheet criteria for banking conglomerates.

6.2.2 The French case

The impact of the French rule 99-07 for consolidation regarding banking conglomerates increased much, once its interpretation had been made more stringent by a joint recommendation of the banking and securities regulator in France in November 2002, both worried about off-balance sheet risks after Enron (interview high official AMF at the time, 06/10/2012). But what motivated this statement by the COB and the CB in 2002 that sharpened the interpretation of 99-07? Besides the startling failure of Enron in 2001 and the supervisory work done on ABCP conduits, it was the consequence of a two year investigation into the use of SPEs of French banks to hide their potential losses from the Latin American debt crisis in the 1980s during the 1990s. French banks outsourced these debts at depreciated values from their balance sheets into SPE's for which they guaranteed the financing and they used the provisions they had built up to cover the losses emanating from these credits to invest them into long-running papers, in this way evacuating all evident risk from their balance sheets (interview representative of the French Banking Federation, 05/03/2011). When asked about the reasons for, and the procedures involved in producing the recommendation, he explains:

I: "and at that time you have been at XYZ bank, did you see the paper (meaning the recommendation) before or ...

W: of course, we discussed this for a long time with the banking commission at that time when completing the paper

I: and how should I understand this process?

W: the goal of this paper was to repatriate on the balance sheet of banks all that which they pushed off-balance sheet in the 90s, probably falsely...

I: so they revised the position, when did they start to send these drafts?

W: in my memory, that was between the years 2000 and 2002”

These remarks exemplify the value in the dialogical nature of banking regulation in France, involving those regulated a long time before the final regulation becomes necessary. In this way, banking conglomerates had enough time to prepare for the increased capital requirements once the decision was issued and the debts needed to be repatriated.

The recommendation also reflected problems with the application of 99-07, as confirmed by an auditing partner in Paris in a technical department.

“and so in implementing, in applying that rule, where there problems from 2000 onwards?

Auditor: yes, regarding the risks and rewards” (interview Paris, 03/22/2011)

In response to these problems, which were partially caused by the novelty of the risk and rewards framework and to impose stricter rules on the conglomerates, the regulators sought further alignment with SIC 12, as it requested consolidation if either the majority of risks or the majority of rewards was detected with any single conglomerate. In the rule 99-07 itself, both criteria needed to be fulfilled at the same time. The way to achieve that was to impose a specific interpretation between the majority of risks and rewards in a reasoning borrowed from financial economics. The two regulatory agencies argued that whoever bore the majority of risks also had to have the majority of rewards as otherwise no professional financial actor would expose itself to these risks and vice versa, reemphasizing the need to apply a risk and rewards approach.¹⁶³

“The banking regulator said, I am with professionals... I know that these professionals know how to manage their risks ... if they support the majority of risks, it is because they have the majority of advantages (interview auditing partner and member of CNCC technical division Paris, 03/22/2011)

¹⁶³ The French text can be found at http://www.amf-france.org/documents/general/4388_1.pdf

This recommendation changed auditors' and enterprise behaviour (same interview) and required restructuring on the part of banks with respect to the distribution of risks and rewards linked to their ABCP-conduits, which led to a reduction in their margins (interview French Bank manager, 03/25/2011). We find an accordant decline in the number of securities arbitrage conduits, which decreased from nine in 1999 to five in 2002 to zero in 2006 (Program Index Moody's), as these securities arbitrage conduits are much more profitable to banking conglomerates if one does not have to distribute the majority of risks and the majority of rewards to other market participants.

¹⁶⁴ Multi-seller conduits which are providing access to the capital markets for clients of the bank were not threatened by this more stringent interpretation, as the majority of risks and rewards usually resides with the clients, which compensate the banking sponsors for their services (an income not available for securities arbitrage conduits).

But the new interpretation did not only aim at bringing about complete convergence between SIC 12 and the French rules. Even more, it sought to install a specifically prudent interpretation of SIC 12 itself. IFRS, as any principles based GAAP is a very malleable framework, shaped as much by those applying it as by those setting the standards. Officially, the interpretation is supposed to be shaped only by IFRIC, the standards interpretation committee of the IASB in order to maintain equivalent applications internationally, explicitly not by national regulators.¹⁶⁵ However, in these practices of applying SIC 12 a quite lenient interpretation had developed. It had become common place for the large auditing networks to focus on the residual risks first and foremost, those which vary with the business success of the ABCP conduit and to ignore the non-residual risks and rewards, and here in particular the fee income (interview auditor technical

¹⁶⁴ In accordance with this view, a French banker pointed to the low margins as the main reason for the small number of ABCP conduits of French banks (interview Paris senior banking manager 03/24/2011).

¹⁶⁵ In Germany, the refusal to seek to influence accounting decisions of auditing networks under IFRS was justified with the need for international equivalence (interview BaFin 07/01/2011, IDW board member 05/03/2011)

department, Duesseldorf 02/21/2011). This interpretation was supported by a *tentative* agreement of the IASB to exclude fee income from the considerations of the majority of advantages, as these are fixed in advance (s. IASB 2002¹⁶⁶). While these tentative agreements are neither rules nor interpretations, but instead simple suggestions because the board did not reach a final agreement yet, such decisions are regularly quoted in the accounting guides of the big 4 auditing networks, thereby having impact on auditing practice (interview German auditors' association, 04/14/2011). This specific suggestion led to a large degree of deconsolidation, even if the sponsor gained the majority of advantages from the SPE through fees (this disregard for fee income was confirmed for the German case, interview bank managers, Frankfurt/Main, 07/12/2011). The recommendation of the two French regulators sought to counter these practices by laying the emphasis on the majority of advantages:

Member of the technical department CNCC : “In the recommendation of COB and CB 2002, the CB says if you have the majority of gains, you are supporting the majority of risks, so it is making the majority of gains the preponderant criterion (interview Paris 03/22/2011)

This recommendation then did not only aim at French GAAP, but also at influencing the way the international auditing networks in France would apply SIC 12, as the recommendation did not only bring about convergence, it sought convergence with a specific interpretation, as the member of the CNCC explains:

“It was regarding French GAAP, but this recommendation made a reference to SIC 12, saying this is what is important, saying, **this is how we read SIC 12...** so especially an international network, which read SIC 12 rather from the control perspective, this contradicted their views (interview Paris 03/22/2011, emphasis mine)

¹⁶⁶ S. <http://archive.iasb.org.uk/docs/update/upd0210.pdf>

By imposing such a strict reading of 99-07, French banking regulation facilitated beneficial innovations regarding securitization, while making its use for off-balance sheet proprietary trading more difficult. Their capacity to detect these conduits as a means of regulatory circumvention stemmed from a good information exchange between on-site and off-site banking supervisors and their strong collaboration with the French authority for financial markets and the auditors' association, as I will explain in the following.

In France, financial innovations are not only supervised by the accounting division of the Banque de France (off-site) , but also by very intense on-site supervision, where regulators would engage their counterparts in the banks in dialogues questioning the purpose of financial innovations they were pursuing. Those on-site inspectors then communicate potentially problematic issues to the accounting division, where these issues are then considered from an accounting perspective.¹⁶⁷

The interaction between these on-site and off-site inspections regarding the topic of ABCP conduits led to an early sensitization of the accounting division towards constructs of sponsoring banks which sought, with the help of ABCP conduits and other SPEs to gain capital relief. In 2001, dialogues between bankers and regulators regarding ABCP conduits took place on-site, where the bankers were asked to explain the purpose of their conduits and for some of these, the bankers could not provide a satisfying answer (interview banking regulator Paris, 01/25/2011). These concerns emanating from the on-site interrogations were transferred to the Commission Bancaire for an off-site debate of the phenomenon, to decide how to deal with it. These analyses were then fed into the meeting between on- and off-site supervisors, which takes place all six weeks in Paris and in which the two teams exchange their views on the new phenomena they

¹⁶⁷ Furthermore, some inspectors of the on-site division are transferred after some time into the off-site division, bringing with them their knowledge about the structuring activities of the banks. For example the career of a director of the accounting division started by 2 years on-site supervision in Paris, followed by one year on-site supervision in New York, before joining the accounting division, interview accounting division of the banking regulator, Paris, 02/03/2011).

encounter, thereby continually updating each other on the newest developments. In these debates, a decision was taken to apply the credit conversion factor to liquidity lines with less than one year which were renewed on the day of expiry for the next year from 2002 onwards, as these were identified

is an instrument for regulatory circumvention (interview banking regulator 01/25/2011, s. Bancaire N° 26_2002, where this rule was first announced).

In addition, the Commission Bancaire is not alone in its monitoring attempts. Instead, given the close interaction between the AMF and the Commission Bancaire, there is further synergy stemming from the monitoring activities of the AMF, which are sensitive to dubious accounting innovations, even if the latter sees the former in a much stronger position due to its monthly reporting requirements (interview manager AMF 04/12/2011). The two agencies are in constant (phone) exchange about accounting issues, updating each other. The advantage of the accounting division of the AMF in this respect is that it is seeking very close contact with the auditing networks and their technical departments. It has become a convention for auditors to inform the AMF not only if an auditor refuses to sign off on a consolidated statement; but also if he voices reservations in the final report. The auditors know that they can call the accounting division anytime they have a problem, even well before the signatures are due (interview AMF, 04/12/2011). When the accounting division of the AMF is encountering a problematic structure, they enrol the accountants of the corporation as well as the technical departments of the auditing networks in its clarification.

Manager AMF:

“when we encounter a more difficult transaction, to be sure that we capture the important aspects, we systematically ask that the corporation makes a technical note in which they are describing the characteristics of the transaction. They have to indicate the standards of relevance to evaluate it and they give us their conclusion.

And we ask that this note is reviewed and validated by the technical department of the auditors... and in this way we have frequent exchanges with the technical departments (interview Paris, 04/12/2011)

Furthermore, there is a one to two day annual joint seminar since 2007, a tradition which before was more sporadic, where the team of the AMF joins a technical department of one of the big four auditing networks in order to learn about the newest developments and problems these departments face when working on the annual audits of large conglomerates. The official explained that exploring new issues is a gratifying task for the auditors at the AMF. At the same time it helps to stay abreast of the newest developments as well as to develop and deepen contacts between the AMF and these technical departments, which can lead to a more efficient flow of information between auditors and the regulators (interview manager at the AMF, 04/12/2011).

These links are also one reason why the recommendation of 2002 did make a difference to the accounting behaviour of banking conglomerates, although neither of these agencies has the legal right to specify certain interpretations, a power which resides with the National Accounting Standards Setter. The reason for this expansion of regulatory clout resides on the one hand in the legitimacy the recommendation obtained through the extensive consultation between the regulators and auditing networks. Every year, the financial market regulator AMF, the technical departments of the large auditing networks as well as a specific committee on technical questions at the Compagnie Nationale des Commissaires aux Comptes (CNCC) communicate intensively before the annual recommendation is issued in November, specifying areas where the AMF seeks improvement (interview AMF manager 04/12/2011). It is a consultative style, which according to a member of the CNCC subcommittee is common to the French regulatory network.

Probed about the fact that the CNCC worked on the COB CB recommendation, the member explained

“in general if the COB and the CB issue a recommendation, they send it for opinion, for consultation, they take it into account or they don’t, we at the CNCC do the same if we publish something we always have the commission bancaire read it in advance. ...this is how it works in France... we stay independent, but we work however in good mutual awareness. One cannot say that we work together, but we work in good awareness, so we were not surprised when it was issued, there is an official response from the CNCC regarding what we think about this recommendation” (Paris, 03/22/2011)

The same mutual information applies to all the statements issued by the technical committee of the CNCC (the French auditors’ association) of how it interprets the proper application of standards, allowing the regulators to take influence upon these as well. What is furthermore important is the fact that the members of this technical committee are leading partners in the local representations of the large auditing networks’ technical departments, thereby making sure that these departments are informed about the views of the regulator. This is especially advantageous for complex questions posed in the application of accounting standards. The decision over the consolidation of SPEs on balance sheets is such a complex issue, which is usually reviewed by the technical departments (interview auditor, technical department of a large auditing network Germany, 02/21/2011).

In addition to the legitimacy gained by consultation, the two regulatory bodies have other means for exerting pressure on corporations to adhere to their interpretations of accounting standards as they have the capacity to punish those who do not adhere to it. Each time a company wants to issue bonds in the French capital market, it needs approval by the AMF for the prospectus informing potential creditors. This approval might be refused or delayed if the accounting of the

corporation is found not to be in accordance with the recommendations of the AMF. As corporations seek to avoid such delays, they conform to these recommendations.

Furthermore, the Commission Bancaire has been granted the right by law to challenge the accounting decisions of the accountants and the auditors of French banking conglomerates (interview accounting division, commission bancaire, 02/03/2011), thereby defining what is and what is not acceptable within the framework of the law (interview Paris 04/19/2011)¹⁶⁸. Especially for the question of consolidation, the Commission Bancaire was vigilante, as confirmed by the statements of an auditing partner of a large auditing network:

“ they were always very present. Absolutely, the auditors, we went to defend our position, well defend, we went with the opinion position on why we accepted for example the non-consolidation for the large conduits, always, they were always very present. ... We had to justify our position, and then to make the calculus, they were always very present, they never let it go, they didn't do a control every day, but everytime one asked the question about these vehicles, they were present”(interview Paris 03/22/2011)

Given this presence, when the Commission Bancaire was issuing its point of view publicly, it signalled problems ahead for accountants and auditors if they failed to live up to the recommendation. While such legal action might fail, it strains the relationship between auditing networks, the banking conglomerate and the banking regulator and is perceived as a stigma in the French auditing community.

W : one has to know that the document took the form of a recommendation, which doesn't have the force of immediate application, only that the auditors, for them it is totally unthinkable to accept and sign a statement that does not respect a recommendation from the CNC, the AMF and the Commission Bancaire, de facto this is a text which has the power of law...

Interviewer: would there be consequences for the person signing it?

¹⁶⁸ The banking regulator explained, that the fantasy of bankers and advocates is unlimited with respect to structuring activities as this constitutes their source of income. In contrast, it is the task of the banking regulator to define what is acceptable within the framework of the law.

W: clearly yes... one has to know that the banking regulator has the powers to refuse the statement of a bank. So, imagine a banking regulator publishing a communiqué which states that the statements of Bank X are false for this and that reason...

I: and that would also be a big problem for example for a large auditing network

W: that is clear.... It is called recommendation, but it could as well be called regulation (Interview representative French banking federation, former employee large auditing network, former bank manager 05/11/2011)

This binding force holds especially as auditors, banking conglomerates and the regulators take part in repeated interactions in which the banking regulator will have the opportunity for retaliation, especially given that the French regulatory style is characterized by a large degree of discretion in the decision making as evidenced by the approach to ABCP conduits, which does not force all ABCP conduits to consolidate, but requires individual investigation (that this is indeed part of the general style of regulation was suggested to me in a conversation with a finance professor Amsterdam 09/06/2011).¹⁶⁹ This constellation of regulatory powers in repeated games and the prior interaction with the auditing networks in formulating these standards makes non-adherence very difficult and costly for the regulated.

We can see this desire for discretion in the reaction of the banking regulator to the changes in the interpretation of 99-07, that were imposed by the Comité d'urgence with the Avis D in 2004 (s. last chapter). As a response, the French banking regulator announced in 2005, that it would disconnect the prudential treatment of SPEs of banking conglomerates from the accounting treatment. It described the rules for consolidation under French GAAP as seriously weakened by these new interpretations and divergent from IFRS (s. Amis and Rospars 2005: 58). It announced that it would from now on apply the Basel framework of significant risk transfer. At first sight, this decision seems to be an overreaction. All of the six large banking conglomerates switched to International Accounting Standards in 2005. In contrast to Germany, the prudential perimeter of

¹⁶⁹ In a public event at Sciences Po on January 25th, a high official of the banking regulator likened the French style of banking regulation to a police cop who assigns different speed limits according to the driver's capability of driving, rather than having a unique speed limit.

consolidation for these banking conglomerates was based on these standards, not on domestic GAAP. Of course, there could have been a concern for those banks not publicly listed nor emitting public debt (forced to use IFRS from 2007 onwards), but the number of banks fulfilling these criteria is rather small. But once one understands that the recommendation in 2002 did not only seek to influence accounting decisions in French GAAP, but also in IFRS, it becomes evident why the Commission Bancaire chose to opt for disconnection. The decisions in 2004 de facto establish a qualifying special purpose entity in French GAAP and signalled to the auditing community that this is what the CNC considers to be appropriate and what the ministry of the economy desires. The Commission Bancaire on the other hand, has been in the body that takes consensual decisions and has not stopped it, thus it is in a very difficult position to attack the leniency which is now permitted in French GAAP. Furthermore, the fact that the recommendation of 2002 is de facto revoked for securitization SPEs means that the application of SIC 12 for French banks will be less stringent than desired by the CB. By decoupling their treatment of these SPEs from the accounting decisions, they gained back the space for discretion to impose prudence which they had lost in the prior political battle in the CNC. Instead of being bound by the accounting decision, they could apply capital charges if they estimated that no significant risk transfer had taken place. These changes did not mean a weakening, but rather a strengthening of economic oversight, as banking regulators could still approve of the consolidation of an SPE and use it for core capital requirements (e-mail exchange, French regulator 06/04/2012, PwC 2006). On the other hand, if no consolidation had occurred it could still request core capital for the assets inside of the SPE, if it deemed them to be substantially part of the conglomerate. This move then continued a tradition at the CB, as a former banking regulator explained:

“what you said about Germany, that when it was deconsolidated in accounting terms, it was deconsolidated in prudential terms, I am not so sure that it was so automatic, because we were often beating ourselves with the banks for SPEs, because they did not like that we did not simply translate one into the other, the prudential did not follow the accounting, it was not automatic” (interview Paris, 01/30/2011)

In contrast to the active style of intervention by the French banking regulator, using its lateral connection with other regulators, in the German case we can observe a banking regulator completely detached from the accounting process.

6.2.3 The case of Germany

The German Banking regulator does not have a separate accounting division to verify the accounting decisions of the banking conglomerates it supervises. Instead, the evaluation of the correct application of accounting decisions has been mostly outsourced to auditors via the ordinance for examination (Pruefverordnung). This leads to the fact that knowledge over accounting issues is clearly placed in the auditing networks, which limits the capacity of the banking regulator to challenge these decisions, for example the off-balance sheet decision. This distribution of responsibilities is clearly acknowledged by a manager at BaFin, asked about the interaction of a banking conglomerate with the BaFin regarding the consolidation status of SPEs:

“Can I consolidate it, yes or no, do I come to BaFin? No. But I have to come to BaFin because it is a new product, and inside of market risks, there is a minimum requirement for new products and so you have to come to BaFin, but not for consolidation“(interview Bonn, 07/01/2011)

Asked about the capacity of the BaFin to challenge the off-balance sheet decisions made between the large firms and the auditors, a regulatory advisor of a large auditing network answered:

“they (BaFin) can doubt everything... but I am thinking if an auditor has looked at the balance sheet part (of the off-balance sheet decision, M.T.), then it will be difficult for the BaFin to formulate concerns, because at least with the large auditing networks the knowledge is at least equivalent to the one at the BaFin (laughs), I

would say this is our original duty. In prudential supervision this might be different as there is a lot of judgment” (interview Frankfurt/Main 06/14/2011)

The one-sided distribution of accounting knowledge is aided by the lack of qualified accounting personnel at the BaFin, where by far less accountants are employed than in one large auditors’ network in Germany alone (interview BaFin 07/01/2011¹⁷⁰). Due to this lack of accounting capabilities necessary to challenge accounting decisions of conglomerates and their auditors, overturning the accounting decisions of an auditor by the financial regulator/ banking regulator is something unheard of (interview banking managers, Frankfurt/Main 07/12/2011).

Another part of on-site supervisions, besides the on-site supervision of accounting decisions outsourced to auditors, is handled by the local agents of the Bundesbank, issuing reports to the BaFin. This delegation of tasks leads to problems in the information flow between on-site and off-site supervision, in that before the crisis the regional Bundesbank officials sent reports upon which the BaFin acted, but there was no institutionalized meeting between these two, where matters could be discussed further. In this respect, the BaFin is isolated from on-site supervision as well as the current accounting practices in the field, which are left to the auditors. This structure of BaFin is an outcome of the federal structure of Germany as well as the desire to enforce the subsidiary principle and to keep the federal agency at its inception in 1962 as small as possible (s. Zimmer 2010).

Regarding the embeddedness of the financial regulator in the field of auditing practices, there is a formal exchange between BaFin and the German auditors’ association IDW that is happening at least once a year, with a specific committees dealing with insurance and banking conglomerates, where views on different topics are exchanged, but these exchanges mostly regard the audit reports for the BaFin, not the financial statements of banking conglomerates (interview BaFin

¹⁷⁰ During the interview, the official from BaFin asked for the exact number of auditors working at BaFin not to be disclosed.

07/01/2011). Besides this meeting, there are no formal or informal conversations of the banking regulator with the auditing networks. The lack of informal conversations with auditors has been remarked as a problem by auditors, which desired such an exchange in order to voice their concerns without putting them into writing (interview German banking professor involved in the official investigation of the German banking supervision after the crisis, 05/24/2011). In this sense, it is difficult for the financial regulator to get a grasp on the latest developments in accounting that causes problems for the technical departments. While banking conglomerates had to approach the banking regulator every time they set up a new securitization SPE, the investigation by BaFin did not consider questions of accounting, thus keeping the contentious off-balance sheet decision out of view. The German banking regulator was therefore lacking much of the capabilities needed to steer accounting standards into a prudent direction, most importantly in the evaluation of accounting decisions of the regulated as well as the legal capacities to challenge them.

This lack of regulatory dialogue in Germany stands in sharp contrast to France, stemming from differences in areas of responsibilities, staffing and legal capacities. The limited legal capacities to challenge accounting decisions also stem from the fact that it is very difficult in Germany to enforce a certain interpretation of accounting standards due to a specificity of the German accounting system. A businessman can defend any accounting act as legally appropriate as long as he can find support for his position in the accounting literature, thereby demonstrating that he is applying the principles of proper accounting (*Grundsätze ordnungsgemäßer Buchführung*). While the BaFin might have the legal power to challenge accounting decisions from a procedural perspective, from a substantive perspective it becomes very difficult to rule out another interpretation of the rules. In the process, the BaFin would need to show that the sources upon

which the business man is basing his decision are not expert opinions but instead interested opinions with no grounding in the rules. This problem is well captured in the following remarks on the capacity to sue of BaFin by a law professor/corporate lawyer:

„this question has a material and a procedural component. The material component is when is an accounting decision in the sense of the material rules mistaken? And if you take the point of view that in those questions where a standard does not provide unambiguous answers to accounting questions, then accounting decisions cannot be mistaken if a defensible position is assumed, then you cannot attack it in the material sense...the first material question remains, also for BaFin and that would be a defence for the corporation, to say BaFin, you are public administration, but you cannot touch use here, because this accounting decision is not wrong, there exists a regulatory vacuum where I have as much right as you do to say what is reasonable (interview 11/06/2011)

This regulatory vacuum is filled by an “active market for legal interpretations” (McLeay et al 2000:96), constituted by “law commentaries and interpretative articles... produced regularly by barristers, judges, auditors, experts from business and the public sector, and academics.”(ibid: 84). This specificity of German accounting rules is made more problematic by the fact that regulatory advisors, seeking to push the interpretation of accounting rules in favour of their clients are publishing in such canonical journals, accepted as sources for the GoB and thereby insert views that are clearly interested, rather than disinterested in the decision making. In the case of accounting for ABCP conduits, there is for example an article of a regulatory advisor that is stretching the rules for the accounting and prudential treatment of SPEs under the new German rules in an attempt to permit further deconsolidation even under the stricter new accounting rules, (s. Thelen-Pischke 2010). Even the independence of academics in this respect has been doubted several times in my interviews, pointing to the sponsorship of these academics by industry (Interview auditor involved in revising the accounting standards, 05/30/2011) and the

commentary writing as a means to provide a possibility for particularly beneficial accounting decisions (interview official DRSC, 05/03/2011).

The only actor with the power to limit these interpretations in German GAAP up until 2006 was the Institut der Deutschen Wirtschaftsprüfer, (IDW, German auditors association), as its pronouncements are seen to be binding for the auditors.¹⁷¹ The IDW is updating its interpretations repeatedly, the ones regarding securitizations (RS HFA 2 and 8) in 2005. After its latest update in 2005 it became more difficult to gain off-balance sheet status for those parties selling credits to an SPE, if the risks of the credit in economic substance remained with the vendor. The formulation of these statements by the IDW is coordinated with the BaFin, as well as the Bundesbank and the banking associations before they are published, as verified by the statement of a regulatory advisor in Frankfurt:

P: “where consolidation was defined away, usually, was when there was no capital link to the SPE, the other topic, economic property, that was treated in RS 8, HFA RS8 in domestic GAAP, ... the off-balance sheet decision for securitization was defined in each single step there

Interviewer: that was an important interpretation?

P: absolutely

Interviewer: and such an interpretation is made in Germany by the IDW?

P: yes, but this is discussed ahead of time with everybody, so also the Bundesbank and the BaFin can take position to such a draft, then it is also sent officially and everybody had it in its hand before (interview 06/14/2011)

The BaFin had the possibility to influence the interpretation of the treatment of securitization transaction in Germany under German GAAP, as did the banking associations in a formal due process and through informal consultations (interview banking manager Frankfurt 07/12/2011).

These rules regarded the necessary risk transfer that needed to be achieved for the derecognition of an asset from the balance sheet of a corporation or a bank which sold an asset to a conduit.

¹⁷¹ This implies that everytime the auditor deviates from the pronouncements of the IDW on certain standards, he needs to justify these deviations, and everytime when an auditor is taken to court over accounting decisions, if he can show that he followed the guidance by the IDW, this is a positive factor in the judge's decision making.

But these rules did not touch upon the relationship between the conduits and their sponsors, where it is notable that most of the time sponsors did not sell their own assets to conduits.

Given that there was no convergence in German GAAP to SIC 12, this tightening of rules by the IDW could make no difference to capital requirements for banking conglomerates for these ABCP conduits themselves (in contrast to the transactions undertaken for the purpose of securitization), as German accounting rules prevented consolidation of these conduits on the balance sheets of banking conglomerates. However, if the BaFin had pushed for the instalment of a SIC 12 like standard, this linkage to the IDW could have functioned as one venue through which the BaFin could have tried to infuse prudence in the demarcation of balance sheets. The German standard setter DRSC was also tasked with issuing interpretations of German GAAP, and thus could have been another organ. However, as explained in the last chapter, there was no institutionalized link between BaFin and the GASB, and interpretations by DRSC needed approval by the ministry of justice to become binding.

6.2.4 Spain

In Spain, the on-site supervision in Spain is described as interrogatory and thorough (interview French banking manager with experience in Spain, 03/25/2011). There are permanent on-site supervision teams in the two largest commercial banking conglomerates and all entities which due to their size and complexity are deemed to justify such permanent staffing (Macuchan 2011: 509). The Spanish banking regulator is the accounting standards setter and supervisor and onsite supervision, a combination of “analysis and verification tasks” (ibid.) are used to supervise the developing accounting practices of the banking conglomerates. The BdE collaborates in the regulation of securitization with the Comisión Nacional del Mercado de Valores, the financial

markets regulator to whom since 1998 all information regarding securitized assets are to be transferred (s. Ramos-Tallada 2010: 60).

Therefore, the banking regulator maintains a very close contact with the accountants of banks and their auditors, as it is the supervisor of their accounting policies (s. http://descuadrando.com/Instituto_de_Contabilidad_y_Auditor%C3%ADa_de_Cuentas). In this function, it directly decides if the accounting decisions are in line with its standards. The bank has the power to issue recommendations to request changes to accounting decisions. Its powers are large, given that it can issue disciplinary proceedings which allow it to intervene in the daily business or even to replace and/or sue the directors and managers of the banks (s. Macuchan 2011: 510).

The dense interaction between the auditors and the regulators, which is particularly characteristic for the French system were favoured by the geographic distribution of the regulatory networks. This is an important factor in the set-up of risk regulation regimes in order to permit the face to face interactions, which can create interpretive communities. I will compare the differences between my different cases in the following.

6.3 The Geographic Distribution of the regulatory networks

Much of the dense regulatory networks and communication channels in France is supported by the physical concentration of regulatory agencies, auditing networks and banking conglomerates in Paris. It especially facilitates the participation of the banking regulator in the accounting standard setting body, which is monthly. In the Netherlands, regulators and banking conglomerates are also situated in the capital and the number of relevant conglomerates is even smaller. Only the large auditing networks seem to be more geographically distributed (besides Amsterdam, Rotterdam seems to be a centre for auditing networks). However, given the

relatively small size of the Netherlands, this should not really inhibit the possibility of meetings. Instead it is the legislation for the AFM, which explicitly hinders this cooperation. In Spain, the majority of large banks, auditing networks and the banking regulator resides in Madrid, with only local Caixas deviating.

Only in Germany does the geographical distribution of regulatory actors, auditing networks as well as banking conglomerates pose a severe problem for frequent personal interaction. While the German standards setter is situated in Berlin, the German banking regulator is situated in Bonn. The German auditing association is situated in Duesseldorf, the German securities regulator is situated in Frankfurt. The headquarters of most private banking conglomerates are also situated in Frankfurt, whereas the large Landesbanken have their headquarters in the capitals of the different Laender. The agencies responsible for on-site supervision are situated in the different capitals, whereas the off-site supervision is distributed between the Bundesbank in Frankfurt and the BaFin in Bonn. This physical distribution inhibits personal contact and might, at least in the past have been a reason for the lack of interaction. With modern information technology, the physical distribution should increasingly play a diminishing role. However, if the lack of a interactive tradition in the risk regulation regime continues, these new opportunities will not be exploited.

6.4 Comparison of the four cases

In the table below I have created a comparison of the four risk regulatory regimes in their most important aspects, particularly the role of the banking regulators in it. The table brings to the fore the likelihood between the Spanish and the French banking regulators on the one hand, and the Dutch and German regarding their embeddedness in the risk regulatory system.

Country	Germany	Netherlands	France	Spain
Connection of the banking regulator to the accounting world	Almost non-existent, large delegation to IDW and WPs	Almost non-existent, large delegation to auditors	Very high, from accounting legislation with the CB to sharing it with CNC	High, Banking regulator supervises accounting for banking conglomerates
What is the collaboration between auditors association and banking regulator developing interpretations	once a year, formal exchange, banking regulator sees drafts of the interpretations before they are published, can comment	None, because auditing body is not issuing interpretations/recommendations	Interaction between CNCC and AMF/CB before regulators or auditors organization are publishing recommendations	Interaction between auditors' association and banking regulator when formulating new rules for banking conglomerates
Interpretations issued by banking regulator/ financial regulator	No	No	Yes	Yes
regulatory dialogues (on-site, off-site)	In writing, as auditors and the central bank work on-site while the BaFin works off-site.	In writing and in person, as DNB is on- and off-site.	In writing and in person, all 6 weeks institutionalized meetings	In writing and in person, very strict supervision regime
Perception of the causal relationship between regulation and the existence of SPES and the dangers posed by them	Low, only Deutsche Bundesbank: measure of regulatory circumvention (1997)	Problem of liquidity, the central bank is kicked out from standard setter, goes it alone in a different way	High, problems of not accounting for risks and liquidity	High, problems of not accounting for risks and liquidity
Different means of regulating off-balance sheet exposure of banks before 2008	No (also due to blockage of ministry of finance)	Yes, from 2003 onwards liquidity coverage ratio, rather an effect of serendipity as the measure was not explicitly directed towards ABCP conduits (interview DNB 09/09/2011)	Yes, from 2002 onwards via capital requirements (20% credit conversion factor) for liquidity lines of less than one year, if renewed	Yes, from 2002 onwards via capital requirements (100% credit conversion factor) for liquidity lines of less than one year, if renewed
Regulatory collaboration	BaFin contains the securities, banking and insurance regulator, collaboration hampered however by physical distance	AFM and DNB cannot collaborate on the matter of accounting decisions.	AMF and CB collaborate, e.g. the recommendation of 2002, phone calls, collaboration with auditors association and technical departments	Banco de Espana and Spanish securities regulators do collaborate

			regarding inquiries	
physical distribution	Frankfurt, Bonn, Duesseldorf, Berlin, capital of the Laender	Amsterdam, Rotterdam	Paris	Madrid and regional capitals
Accounting decisions and the banking regulator	Outsourced to the auditors, annual meetings to clarify the special duties auditors have regarding their audit report to the regulator, but these mostly don't deal with accounting decisions	Outsourced to the auditors, several times a year the DNB informs the auditors of the special duties of the auditors for the central bank	Can be contested by the banking regulator	Can be contested by the banking regulator

Table 6.1: Monitoring and Enforcement in the four risk regulation regimes

Spanish and French banking regulators were included in the networks of accounting governance in such a way that they were capable of gathering independent information and were monitoring the accounting activities of their banks. For this reason it was easier for them to detect ABCP-conduits as a technique of regulatory circumvention. If the regulator was disembedded from this circuit of information, there was the danger of “cognitive closure” regarding the acts of creative compliance in securitization (Aalbers et al. 2011 p. 1790). Critical debates with bankers and with auditors regarding the criteria for the off-balance sheet decision for these conduits could buffer the regulators from claims of financial engineers which declared that these conduits were risk-free as the debate over who bears the majority of risk and rewards, embedded in SIC 12 sensitizes the regulator to the final distribution of risk from these constructs. The logic of this debate is well summarized by a regulatory advisor reflecting upon ABCP conduits:

„And it is also a very simple truth, risks cannot disappear. And you will always find a financial engineer, that claims that afterwards there is no more risk; and that cannot work, not according to commercial law, neither to supervisory law. That means if it leaves from one, it has to arrive at the other, and if it does not arrive at the other it has not left the first one. And then he has to back it up with equity.” (interview Frankfurt 06/14/2011, translation M.T.)

The comparison furthermore shows that in order to make sure that the risks are represented more prudently on the balance sheets of banking conglomerates and that they are not “spirited away” by financial engineers requires not only the change of accounting standards, but also the enforcement of their prudent interpretation. Good accounting standards are only a necessary, but not a sufficient condition to deal with the problematic. The case of Netherlands is paradigmatic for this aspect. While a SIC 12 style rule is introduced in 2001, this rule does not immediately impact the actual behaviour of the auditing networks. The standard setter, who was monitoring the application of the national translation of SIC 12 between 2001 and 2005 critically, did not have any tool to intervene to impose a more prudent interpretation of the standard. On the other hand, the banking regulator failed to develop any critical stance to ABCP conduits, due to the lack of independent information gathering capacities and monitoring. What is needed, is the power of a state regulator to enforce a certain view by imposing sanctions on the members of the community of practitioners if they deviate. Linked to this is the question who defines when a mistake in accounting practice has occurred and under which conditions.

In France and Spain, it is the task of the banking regulator to define what is acceptable within the framework of the law, which allows them to push through more prudent interpretations of the rules. In the Netherlands, the domestic GAAP-standards are non-binding, and enforcement is very weak until this day. In Germany, while domestic standards are binding, everything that is not defined in the standards is defined via a grey literature that is partially produced by those it seeks to regulate. If the banking regulator has the capacity to define right and wrong in the application of accounting rules, he can limit such self-interested interpretations. This capacity allows the regulators to install a second line of control of the application of

standards after the external auditors, controlling the controllers so to speak. In addition, these enforcement activities contribute to the monitoring capabilities of the regulator.

These legal capacities to challenge accounting decisions need to be supported by capabilities in the component information gathering and monitoring, which differs markedly between the four cases. The German and Dutch banking regulator are mostly excluded from the field of accounting practice, as they have outsourced most of these tasks to auditors. They lack the institutional linkages as well as the capabilities for a regulatory dialogue in this field with the large international auditing networks. Information gathering and monitoring is much stronger in France, where the Commission Bancaire and the Autorité des Marchés Financières collaborate and seek to gain information from the technical departments of the large auditing networks. While these links do not necessarily lead to collaborative efforts, they nevertheless ensure that to the different actors in the field of governance can work “en bonne intelligence”, as an auditor from a technical department in France stated it, thereby making sure that each actor is informed of what the other one is doing and no actor is caused by surprise of regulatory action by another one.¹⁷² In Spain, the contact between banking regulator and auditing networks is close given that the on-site supervision includes the control of the application of these rules and that the banks have to apply the rules of the banking regulator.

Comparing the four cases from an integrated systems perspective, Spain seems to be the ideal-typical risk regulation regime with respect to practices of regulatory circumvention in accounting policies, because the banking regulator who could potentially suffer from bad accounting practices has direct control over it. This finds its expression in the toughest prudential regime for ABCP conduits. The French system is close behind, with its strong linkage to the

¹⁷² The reader shall contrast this mode of operation in France with the surprise the banking regulator in Germany had when informed by the accounting standard setter that there should be a rule change for consolidation.

auditing community and the power of its regulators to impose their more prudent interpretation of standards, at least temporarily. In Germany and the Netherlands, the banking regulators were rather blind to developments in accounting, did not have a strong linkage to the accounting standards setter. Furthermore, they neither had the capabilities of formulating more prudent views on accounting, nor legal or other powers to impose these views. These structural weaknesses in the supervision of this sector were amplified in Germany by the pro-securitization stance of the ministry of finance which had the control over the banking regulator.

6.5 Conclusions

The delegation of the implementation of rules to the regulated themselves represents a new form of regulation, which emphasizes the “multitude of actors which constitute a regulatory regime in a particular domain” (Black 2008: 8). This hybridization of regulation, is on the one hand drawing in external expertise, but on the other hand requires many regulatory conversations between the regulator and the regulated as to the meaning of the principles (ibid. p.9). This need for mutual exchange (regulatory conversations) and the drawing in of external expertise requires the existence of regulatory networks, which include all actors engaged in accounting and link them with the financial and banking regulator in order for tacit knowledge to flow from practitioners to regulators and to transmit interpretations from regulators to practitioners.

Holding finance accountable as a process means to hold them to account over their action in front of the regulator, to have them explain why they are doing what they are doing. If they cannot do so, regulatory circumvention is detected. For such dialogues, a principles rather than a rules based approach is advantageous, as in a rules based approach it is much more difficult to have an inquiring conversation of that kind, as it is replaced by a check list approach. In the

realm of accounting, these dialogues need to be backed by the legal capacities of the banking regulator to doubt accounting decisions, as this increases the incentive for bankers to come and check with the regulator before the set-up of such vehicles. Lawyers and regulatory advisors of corporations favour a legal form approach, so that their structuring activity becomes easier and more certain. Regulators can and should deny that in order to be able to enforce regulation in the spirit of the law, rather than the letter. Auditors, on a principles based approach are much easier to influence by a regulatory voice, if backed up by sanctioning power. In this respect, the powers of the regulator to blame and shame auditors are important, but it requires more. It requires the capacity to harm corporations for imprudent accounting practices, as in the case of the French prospectus regulation. Then a quarrel with the supervisor becomes a serious threat to the corporation and the regulator can through this channel impose his views.

In such a regulatory regime, auditors are paid by the company to keep the books in order so that there will be no trouble with authorities. Besides saving money on taxes and optimizing financial data, this becomes the third function of auditors. In this function, financial supervisors have leverage over auditors to minimize their activities in the other two functions. Indeed, financial supervisors can indicate what they accept and don't accept and which conventions they favour in the first two dimensions (mostly financial data) by help of the third function. For banking regulation, this impetus towards regulatory dialogues raises the question of costs of regulation and capacity of regulators to supervise a large amount of institutions.

To these concerns, there are three answers: first, regulatory circumvention can cause large scale negative social externalities and from this perspective, close supervision is worth the costs. Second, it is not necessary to supervise all financial institutions as intensely, as the social externalities caused by failure increase by size. These cost-reduction measures can also include

the co-optation of the technical departments of auditing networks, as shown for the case of France. The third answer is that only by employing capable supervisors which take a stance on structuring activities of the banking conglomerates and confront these banking conglomerates in the standards setting procedures can the employees of banking conglomerates and auditors be imbued with respect for the authorities, a respect which was voiced repeatedly in the French context. Good regulation is the outcome of intensive regulatory dialogues which permits tight control by the regulator over a quickly innovating sector. The differential development of the ABCP market segment in different countries, based on regulatory arbitrage is, I argue, a consequence of the variation of these dialogues, which were going on over years. The qualitative difference of these dialogues was suddenly revealed by the crisis. This view was also expressed by a manager of the French Financial Regulator AMF, noting the difficulty of justifying the costs of regulation in normal times:

“And the problem with the good control is that it shows itself at a specific moment, it does not show itself today, it shows itself in ten years. It shows after something has not happened in your place, but somewhere else, which takes time” (interview Paris 04/12/2011)

The fact that French banks saw their space of manoeuvre in the off-balance sheet realm massively constrained by the banking regulator is a very important reason why the impact of the ABCP market on French banks was so small, why “something has not happened in your place, but somewhere else”.

In the next chapter, I investigate if the correlation between the role of banking regulators in accounting standard setting and prudent regulation holds beyond my four cases. In order to do that, I will expand my sample to include Italy, Belgium, the UK, Portugal, Canada as well as the US. I thereby cover all important ABCP markets before the crisis, but for Japan¹⁷³. I will

¹⁷³ Japan was omitted due to language problems.

furthermore ask why we see so scarce regulatory activity to close regulatory loopholes before the financial crisis of 2007, given that the problems of regulatory arbitrage were known since 1999. The answer, I suggest, resides in the global character of a market, which is nationally regulated.

Chapter 7: IN THE SHADOW OF BASEL: HOW COMPETITIVE POLITICS KEPT

ABCP CONDUITS IN THE SHADOW

“As the centrepiece for capital regulation to avoid crises, the Basel approach has failed in its first and second formulations, and the world is still dealing with the after-effects of the greatest financial crisis since the Great Depression.” (Blundell-Wignall and Atkinson 2010: 11f)

7.1 Introduction

In chapter five and chapter six we focused on the reconfiguration of national policy networks in accounting due to transnational pressures and the impact this had on the transition to SIC-12-like rules and its enforcement. In this chapter I situate these different evolving national regulatory frameworks within the developing international response to the problems of regulatory arbitrage occurring in the field of securitization. This last empirical chapter is seeking to resolve the puzzle posed at the outset of the dissertation at a global level: why did banking regulators around the globe permit their banks to evade the rules of banking regulation by acting in the the bank-based shadow banking system before the crisis of 2007, given that banking systems are one of the most supervised and regulated sectors in the economy? Did they not know what was happening? Did they not know what to do? Or was there some other, structural reason which prevented them from closing the regulatory loopholes?

I will provide evidence against the hypothesis that banking regulators did not understand the dynamics of regulatory arbitrage driving the growth of this sector. Actually, the detection of regulatory arbitrage in this sector was a substantial motivation for the revision of the Basel Accord and in the process regulators developed measures to close regulatory loopholes.

Instead of a lack of knowledge or a lack of options to deal with the problem (which existed, as evidenced by proposals in the revision of the Basel accord from 2001 to 2004), I argue that

regulatory inaction was caused by the mismatch between the level at which the problem occurred (globally) and the level at which banking regulators could address it (nationally). Whereas internationally more stringent standards for core capital requirements were introduced to level the competitive playing field, the undefined scope of application of these rules led to the national reappearance of concerns over competitive disadvantages. This multilevel dynamic in banking regulation dislocated the problem of competitive disadvantages from the centre of banking regulation to the margins of the Basel Accord, the shadow banking sector. In the shadow banking system, regulatory arbitrage of banks to circumvent costly capital requirements coincided with unresolved frictions between national and international banking regulation, which led to inaction by national regulators. Internationally regulated capital requirements (the Basel Accords) not only created incentives for regulatory arbitrage, which fuelled securitization, it also created the structural alignment of national regulators with their domestic banking industry to support this regulatory arbitrage, up until the moment when this regulatory arbitrage would be addressed simultaneously in all relevant legislations through the coming into force of Basel 2. The structural alignment expressed itself in an exemption of securitization activities of banks from banking supervision and regulation.

Pozsar et al list cross border regulatory systems arbitrage, regulatory, tax and economic capital arbitrage and ratings arbitrage (2010:29) as the most important sources for the growth of the internal shadow bank system. They hypothesize that

“these arbitrage opportunities emerged from 1. the fractured nature of the global financial regulatory framework; the dependence of capital adequacy rules (Basel II) on credit ratings; and 3. a collection of one-off, uncoordinated decisions by accounting and regulatory bodies regarding the accounting and regulatory capital treatment of certain exposures and lending and asset management activities.” (ibid: p.29f).

This chapter will suggest that these “one-off, uncoordinated decisions by accounting and regulatory bodies” were structured by “the fractured nature of the global financial regulatory framework”, inducing a dynamic of regulatory exemptions for the internal shadow banking sector. In order to test this argument, I have increased my sample beyond the cases I study in depth (France, Germany, Spain and the Netherlands) to include the USA, Canada, Portugal, Italy Belgium and the UK, bringing the number of countries investigated to ten (in the case of regulatory treatment of SPEs even to 15). For these countries, documentary analysis and short surveys with experts were used to establish the development of the regulatory regimes, complemented by interviews with Canadian and American banking and accounting regulators. I am thereby able to cover the most important markets for short-term-securitization globally, except for Japan where language barriers inhibited documentary analysis.

Studying these dynamics of market regulation, one needs to transcend certain methodological shortfalls common to International and Comparative political economy. The national regulation of international markets does not happen on a mostly independent basis in different countries (CPE) and negotiations between states over international regulation are often not be the most important arena of decision making (IPE, s. e.g. Singer 2007¹⁷⁴). Nation states might enact regulation when there is no international consensus in sight or in the interim phase, when an international agreement is made, but has a long implementation phase (which holds especially for financial regulation; Basel 3, agreed upon in 2011, will be fully implemented in 2019). This chapter deals with such a problematic as I am not focusing on the international negotiations over the regulation of securitization itself (lasting from 1998 to 2004). Instead I am

¹⁷⁴ Singer’s focus on the domestic situation of regulators and his observation that “no regulator wants to be held responsible for crushing an industry under the weight of onerous regulation. Regulators therefore must walk a fine line between stability and competitiveness.” (Singer 2007: 23) is, however of importance to the situation analyzed in this study.

focusing on the formation of national regimes in the interim interval, from the time the new international regime is negotiated until it is implemented in 2008.

7.2 Competitive pressures in the national regulation of global financial markets

The ABCP market is a global market, but the conditions under which banks compete in it are determined nationally. Such national regulation could either hinder or permit their participation in the market and shape their competitiveness with respect to banks from other regulatory backgrounds. Through the ABCP-business, local credits are linked to global wholesale financial markets via banks. The rule of home country regulation, primary element of international banking regulation since the first Basel Concordat in 1975 (s. Herring 2007: 202f), undermined the capacity of national regulators to impose common regulation for domestic and foreign banks in this business on their national grounds. This implied that if foreign banks had laxer regulation, they could securitize local credits according to their domestic rules which carried less costs for supervision and thereby drive domestic banks out of the market for short-term securitization.

As one lesson of the global financial crisis, some scholars of the international political economy have started to pay more attention to these contradictory forces immanent in the national regulation of a global market (s. Mosley and Singer 2009: 422¹⁷⁵). In these contributions, the regulation of international markets, sitting at “the nexus between national and international affairs” (Farrell and Newman 2010: 630) has been of crucial concern (s. also Mosley 2010, critical Drezner 2010). In order to gain a better understanding how these domestic regulatory rules are shaped, we need to attend to “*international market regulation* – the

¹⁷⁵ For one of the first theoretical statements pointing to the internal (!) transformation of nation states in response to globalization, s. Sassen 1996. In this view, globalization has become endogenous to the nation state (s. also Sassen 2006).

processes through which the domestic regulatory activities of states and other actors set the effective rules of internationally-exposed markets.” (Farrell and Newman 2010: p. 610). “*Cross border relative sequencing effects*” (Farrell and Newman 2010: 623, italics in original) have been identified as an important mechanism shaping these national policy regimes, as a “policy decision taken by one regulator in one national system may have substantial direct or indirect consequences for the ability of other regulators to pursue their objectives in their national markets” (ibid: 613). These sequencing effects are of particular importance when international regulatory frameworks are still developing. In this situation, international proposals such as the Basel 2 framework or developments in international accounting standards concerning off-balance sheet financing are options to choose from for domestic regulatory actors in the interim phase according to their preferences. As Schneiberg and Bartley have pointed out, regulators need to be able to adopt fast to the innovations of financial engineers (s. Schneiberg and Bartley 2010), which is impossible if regulators wait for the implementation of international financial regulation.

At the same time, the lack of international agreement generates the forces which prevent the effective regulation of international markets domestically, even if the regulators prefer it. In these interim periods, authority over the market remains partial, fragmented and uncertain (Underhill 1997b: 18) and “the danger is that the obstacles to cooperation weigh down the capacity of the regulatory policy makers to keep up with market innovation and growth.” (ibid: 20). National decisions in the interim period are often characterized by concerns over an even playing field for domestic actors and regulatory competition, where domestic agencies are removing regulatory restrictions or oversight in order to permit domestic market players to gain a greater market share (Underhill 1997a: 6). The literature on the integration of financial markets

in Europe has, in this respect, pointed out the sensitivity of financial products and services to regulation itself.

“But a fundamental point about financial markets is that they are uniquely sensitive to regulatory conditions, since for the most part the things they trade are themselves regulatory creations: financial instruments.” (Moran 2002: 268).

Competitiveness of national financial industries hinges on the capacity to shape and circumvent regulation, putting domestic financial regulators into a conflict between competing goals, guaranteeing financial stability and the competitiveness of their regulated industry (Moran 2002, s. Coleman 2001). In the struggle to maintain or gain competitive advantages for their national financial centres through rule making, legislators and financial industry become aligned in their interests with the industry (s. Moran 2002: 270). In this respect, the literature highlights the interactions between changes on the European level of financial governance with systems of national financial governance, as well as the evolving global system (s. inter alia Moran 2002, Quaglia 2007, Muegge 2010, for a general approach s. Clift and Woll 2012) and emphasizes the symbiotic relationships between these different levels, “inextricably twined round each other, sometimes supporting, sometimes dragging down.” (Moran 2002: 257). The lack of common regulation for securitization activities of banking conglomerates in the European Union and the US, at the same time that banking conglomerates from these different regulatory backgrounds were forced to compete with each other in this market imposed the structural conditions for a regulatory ‘competition in laxity’ (Murphy 2004) as this chapter will show. To investigate the directions of the national regulations of global markets toward stringency or laxity, Murphy distinguishes between market access restrictions and production process regulations. He sees the former category as one that permits regulatory convergence towards a higher common denominator, as nations with large domestic markets can impose their views on other countries.

Production process regulation, on the other hand tends to lead to regulatory convergence towards a lower common denominator (ibid: 6-8), as regulatory costs directly impact the competitiveness of the domestic industry.

The global nature of the market, enshrined in the acceptance of foreign banking regulatory frameworks on domestic soil called home country regulation, established by the first Basel Concordat in 1975 (Herring 2007: 202) made domestic regulatory action to constrain market access impossible. This shifted the balance of power between industry and regulators to such a degree that even a hegemonic power in international finance, the USA chose to implement laxer regulatory measures in the interim period than it had initially envisioned, due to competitiveness concerns. This accommodative stance to requests of industry contradicts the view held in International Political Economy that hegemonic powers will impose the regulatory innovations they see fit, independent of their external effects (Simmons 2004¹⁷⁶, s. also Drezner 2007, both of them responding to authors such as Strange 1996, 1998 which came to the conclusion that markets had outgrown governments). These theories of the persistent regulatory power of large states in the phase of the current globalization fail, because their main theoretical argument, that the threat of market access restrictions allows countries to protect domestic industries and impose desired regulations on foreign jurisdictions (s. Murphy 2004: 13) does not operate. This lack of power, in conjunction with heterogeneous process regulation for the production of ABCP induces competition in laxity (ibid: 6). The discrepancy between the assessment of a financial innovation which represents regulatory arbitrage and the incapacity to regulate against it on a national level leads to a situation in which measures of regulatory arbitrage are **tolerated** by domestic regulators until a global response is formulated. The case of

¹⁷⁶ “Because the dominant power has already determined that the regulatory innovation is in its own domestic interest, no combination of responses on the part of the rest of the world’s regulators will cause it to alter its own internal regulatory stance.” (Simmons 2004, p. 50)

the regulation of ABCP-conduits is a stark example of economic globalization outpacing political globalization (s. Stiglitz 2008: 71).

I will show that this laxity was widespread with respect to the three entry points banking regulators had for the regulation of the ABCP-business. The first one is centred around the question if and how to regulate and supervise the ABCP-conduits themselves, as these are active agents in financial markets, emitting commercial papers into financial markets and buying up debt. The second one regards the question if the SPE should be deemed a subsidiary of the banking conglomerate which is sponsoring it in prudential terms. This status would imply the application of core capital requirements to the assets inside of the SPE. The third access point pertains to the liquidity lines granted by the banking conglomerates to the ABCP conduits. The question was if banking regulators should apply capital requirements to these vital support mechanisms, without which the conduit could not exist. All of these three access points were not regulated in the international regulatory framework, Basel 1 as it was in the spots unregulated by Basel that the securitization technique flourished.

7.3 The blind spots of the Basel Accords and securitization

The first Basel Accord was signed in 1988 and agreed on internationally shared core capital requirements for banks. It was itself a reaction to the problems caused by international competition under national rules. American banks, which in the 70s came under competitive pressure from non-bank financial institutions as well as foreign competitors had reacted to this challenge by reducing their core capital (s. Kapstein 1991: 5) which seriously endangered the solvency of the American banking system once the Latin American Debt Crisis hit in the 80s. In 1986, as a condition for the recapitalization of American banks, the US congress demanded that

capital requirements had to be raised. US banks complained about the potential loss of competitiveness vis-à-vis foreign competitors on domestic soil, which led US regulatory agencies to engage in regulatory diplomacy.¹⁷⁷ They established an international agreement in 1988 that agreed on common core capital requirements, hailed as an example that international cooperation can be forthcoming “if great powers seek them for domestic reasons.”(Kapstein 1991: 32).

The two fundamental objectives of the Accord were to address level playing field and financial stability concerns at the same time (s. BCBS 1988: 1). In order to grapple with the complexities of an internationally branched out banking system with thousands of subsidiaries, the Basel Concordat had introduced the concept of “consolidated supervision” in 1979 (s. Herring 2007: 203). It was to give “practical effect to the principle of parental responsibility (s. Kapstein 1991: 6), as international banking conglomerates had used foreign subsidiaries to evade regulation in the home country. Regulation would now be applied based on consolidated balance sheets of banking groups, including subsidiaries undertaking banking and financial business. This principle became a central pillar of the first Basel Accord (s. BCBS 1988: p. 3, point 10). But, as a regulatory answer to evasion, it by no means ended evasion. Instead it shifted evasion onto the outer margins of banking conglomerates’ balance sheets, the bank-based shadow banking sector.

Observers at the time noted that with the accord “an important source for competitive inequity was reduced globally” (Kapstein 1991: 24), but feared the lax national implementation

¹⁷⁷ Some accounts, ascribe more agency to the Fed itself, having realized the consequences of globalization for domestic regulatory policy, especially the threat posed by lax regulation in other countries to the health and competitiveness of its own financial system (Reinicke 1995, p. 3). “There is a sense in which all of us, perhaps in this area more dramatically than in other areas, lose sovereignty in developing regulations and supervision that is just directed toward our domestic markets” (Paul Volcker in a speech in 1987, quoted in Reinicke 1995: p. 202).

as stringent interpretations implied competitive disadvantages for national banks and the Basel Committee had no effective tools for supervision¹⁷⁸ (ibid: 26).

But what was more important for the development of shadow banking were the national differences in the scope of prudential supervision, concerning the distinction of banking and financial business from other business and the rules for accounting. These differences were not tackled by the Basel Accord, but instead the common international regulation was placed upon them.

Consolidated balance sheets of banking groups, on which supervision is based are produced nationally according to different accounting principles. They are translated into prudential requirements according to national banking law, which excludes non-financial business from the balance sheet when calculating capital requirements.¹⁷⁹ The Basle Accord made it mandatory to supervise banking conglomerates on a consolidated basis, built on consolidated financial statement, but it could not correct for the differences between national accounting frameworks or for the difference between national banking laws. If accounting frameworks did not require the consolidation of certain organizations and their assets, financial holding companies from these countries did not have to withhold core capital against them. If such consolidation happened, but according to national law these entities were considered non-financial organization, this excluded this information from being used for regulatory capital requirements. The decision to change these frameworks lay entirely in the realm of the national legislative. We thus find in the centre of the international banking accord which aimed at

¹⁷⁸ One area of concern was the definition of capital that can fulfil core capital requirements,, which risk weightings should be assigned and how to treat off-balance sheet items as long as “capital- adequacy standards are met or exceeded”(Kapstein 1991, p. 26). Here the same mechanisms of competitive inequity concerns were at play.

¹⁷⁹ This circumstance is in itself entirely reasonable, as industry participations of banks are not subject to the risk of banking and should thus not be regulated like banks. However, the exact drawing of the regulatory lines became a substantial issue for national lobbying to avert falling under stringent international rules.

reducing competitive inequities, a source of such inequities which could not be influenced by the international accord itself and threatened the levelling of the playing field (s. Scott and Iwahara 1994). The Accord did not resolve the problem of competitive inequities, but instead shifted the problem to the size of the perimeter of supervision and the size of the perimeter of consolidated financial statements.

That Basel is rather under-inclusive with respect to the perimeter of consolidation and supervision was confirmed to me in several interviews with banking regulators in France and Germany. The perimeter of supervision, which activities are supervised by the banking regulator, varies internationally. A French official, speaking of the perimeter of supervision remarks:

Official: “the perimeter of supervision is very important, as no international harmonization on this matter exists. Banking supervision thus happens according to a variable geometry according to the country. In France, it consists of all institutes which grant credit, all those who take deposits, broker-dealers and those issuing means of payments. This is a very large conception, which is not very often the case. In the US, for example, mortgage lending is not supervised by the banking supervision. In Europe there are also important differences.” (interview Paris, 20.04.2011, translated by M.T.)¹⁸⁰

The pride of the French official regarding the extensive scope of supervision in France cannot be overheard. However, when one investigates the question whether ABCP-conduits were included in the realm of banking supervision in Europe, we encounter surprising homogeneity with most of the countries excluding them completely.

¹⁸⁰ In the revised Basel Accord of 2004, there is acknowledgement of the international diversity on consolidation regarding securities activities and other financial entities and the role of national law in determining what will be consolidated for regulatory capital purposes (s. BCBS: 2004, 7). Despite the persistence of these problems, the supervision on a consolidated basis is maintained in the Accord, hailed as the best possible means to achieve the integrity of regulatory capital (ibid: point 20).

7.4 Stretching the law to permit securitization business

When the crisis hit, few regulators had precise knowledge about the assets SPEs held, their quality and their potential for deterioration.

“The crisis demonstrated both the difficulty of capturing, and the importance of, sound indicators of the degree and location of leverage or excessive risk-taking within the system, particularly as regards unregulated or lightly regulated institutions and instruments (the “shadow banking system”)” (Burgi-Schmelz et al 2011:15)

The reason for this lack of data for the ABCP sector resided in the systematic exclusion of SPEs from supervision in Europe, which, as will be shown, was a conscious policy decision. The European banking directive specifies that in order to qualify as a credit institution, two cumulative criteria must be met: to receive deposits or other repayable funds from the public and to grant credits for its own accounts. (s. 77/780/EEC Article 1, becoming part of 89/646/EEC, 2000/12/EC, 2006/48/EC,¹⁸¹). If an entity is seen to fulfil both of these criteria, it immediately falls under the banking supervision and needs to comply with all requirements to be permitted to engage in the business of credit institutions (including the ownership of sufficient core capital). Special purpose entities that engage in the selling of asset-backed commercial paper in the money market (or asset-backed securities in the market for longer term maturities) and buy up asset-backed securities might be qualified as a credit institution. However, the business model of ABCP conduits which relies on miniscule equity is incompatible with such a status, which means that if a country applied such regulation, no ABCP conduits would be set up in this jurisdiction. As a consequence of this fact, laws were changed and derogations granted in order to exempt

¹⁸¹ These acronyms stand for the first and second directive on the coordination of laws, regulation and administrative provisions relating to the take up and pursuit of the business of credit institutions from 1977 and 1989, the Second Banking Directive from 2000 and the Capital Requirements Directive from 2006. All of these documents are available on the internet upon entering the acronyms above, the first number standing for the year of issuance.

securitization SPEs from this status (s. European Financial Markets Lawyers Group 2007a, b, hereafter EFMLG 2007a, b).¹⁸²

When the SPE buys an asset-backed security from a seller, the SPE is in fact paying money now for cash flows emerging from this asset-backed security in the future, for which the seller is the creditor. It is thus indirectly linked to a credit-activity by financing the creditor rather than the credit itself¹⁸³, and the question is, does such indirect linkage constitute credit activity or not? That the answer should be yes to this question is most evident in the case of France:

“Under French law, acquiring receivables on a regular basis constitutes a credit operation since the assignee has to provide immediately to the assignor sums in respect of claims for which the assignor is indeed a creditor but these claims only fall due in the future. (EFMLG 2007a: 26). However, France does not apply these rules to its domestic securitization vehicles, based on an implicit derogation, building on the understanding that they do not constitute credit institutions.¹⁸⁴ If securitization SPEs are not considered credit institutions, a second issue emerges over the question if selling Asset-Backed Commercial Paper or Asset-Backed Securities into the money market does or does not constitute the ‘taking of repayable funds from the public’. Without being classified as credit institutions, the European Banking Directives (2000/12/EC Article 3, 2006/48/EC, Article 5) prohibited them from engaging in this activity.

“Furthermore, in view of the prohibition on undertakings other than credit institutions, under the Banking Directive, from carrying on the business of taking deposits or other repayable funds from the public, the question arises of whether the issuance of bonds by securitisation undertakings should be considered as an activity of ‘taking repayable funds from the public’” (EFMLG 2007a: 26f).

¹⁸² The EFMLG is a lobby group of corporate lawyers concerned with securitization. They documented these rule changes, based on a large scale European questionnaire of their members.

¹⁸³ Or, in a longer chain of transactions, financing the financier of a credit transaction (SPE buying from an SPE), or financing the financier of a financier of a credit transaction (SPE buying from an SPE buying from an SPE).

¹⁸⁴ This however creates legal uncertainty for the status of foreign SPEs operating in France as the EFMLG notes: “Foreign securitization vehicles risk being considered as infringing French banking law rules” (ibid)

In order to deal with these legal constraints while still facilitating the issuance of asset-backed commercial papers in their domestic markets, most European legislators have chosen to issue an exemption for those securitization SPEs which are issuing funds starting with 50000 Euro to “institutional or professional investors on their own behalf” (p.28), rather than the general public. Doing so allowed the circumvention of the prohibition in the European Directive as well as relaxing the regulatory supervision to minimal to none (ibid., s. table below). The need for legal accommodation of the nation state to the practices of securitization special purpose entities becomes entirely clear in these actions. States were changing their laws (Austria 2005, the Netherlands 1997¹⁸⁵), opening up loopholes (France) and in case of doubt all opting for a restrictive understanding of credit institutions in order not to endanger business models of securitization SPEs. The decision to treat securitization SPEs explicitly not as credit institutions **is the regulatory foundation, the sine qua non of the securitization business.** Regulators chose to ignore the intermediate function of credit provision these SPEs fulfilled. But most regulators went even further than that, exempting securitization SPEs also from the status as financial institutions (s. table 1 below).

Since the Second Directive of the European Community in 1989, a financial institution is defined as not engaging in deposit taking, but engaging in lending activities, financial leasing, factoring or portfolio management advice, moneybroking, safekeeping and administration of securities or trading for own account or for others in transferable securities. (s. 89/646/EEC, Annex). If securitization-SPEs are not credit institutions, they are at least trading in transferable securities for themselves or for others, making the fact that it was most often not qualified as a financial institution remarkable (only four of the fifteen countries analyzed classified them as

¹⁸⁵ This was the direct motivation of the regulatory changes in the Netherlands, as a Dutch banking manager confirmed, personal correspondence Dutch bank manager concerned with securitization (12/07/2011).

financial institutions, s. table below). It means a lack of supervision which on the one hand reduces the regulatory burden on securitization-SPE, and thus the costs for the securitization business. But on the other hand, it also implies a lack of data regarding the assets held by SPEs for the regulator.

Country	SPEs considered a credit institution	SPE considered a financial institution	SPE under the supervision of the banking supervisor/ financial markets supervisor	No supervision
Austria	No (explicit in banking law since 1 st of July 2005), before yes	No	No	Yes
Belgium	In principle yes, but thanks to by Royal Decree of 7 July 1999, no (EFMLG 2007a: 27)	No	If funded publicly, yes, if funded privately ministry of finance.	If funded privately
Denmark	No	No	Yes	
Finland	No	Yes	Yes (banking supervisor)	
France	Yes, but exemption for national SPEs	No, but the fund who is managing the SPE is	Custodians of SPEs are supervised, FCCs not, banking and financial supervisor	
Germany	No	No	No	Yes
Greece	No	No	No, because there is only private placement	Yes
Ireland	No	No	No	Yes
Italy	No	Yes	Banca d'Italia (information on notes and assets)	
Luxemburg	No	No	Yes, the financial supervisor, if issued to the public (i.e. not to professional investors)	If issued irregularly
Netherlands	Yes, but exemption in banking law which allows it to be considered not as such if only issuing	No, unless it is a credit institution	No; unless deemed a credit institution	Yes

	to professional investors			
Portugal	No	No, but the fund who is managing the SPE is considered to be a financial institution	Yes, if the sponsor is a bank, then both by financial and banking supervisor	
Spain	No	No, but the fund who is managing the SPE is considered to be a financial institution	Financial Market Supervisor	
Sweden	Yes (unless it issues securities only occasionally, s. EFMLG 2007b: 15)	No	If funded publicly yes	If funded privately
England/Wales	No	No	No	Yes

Table 7.1: the classification of securitization SPEs in Western European EU members and the US¹⁸⁶

Regulatory competition hampered the regulation of ABCP, as these are regulated according to the rules of the country in which they were incorporated. Given that there is no constraint for banking conglomerates to install ABCP-conduits where they see fit, banks would set-up their conduits where the costs of operating them (including regulations) was lowest. This fact put national governments into regulatory competition, seeking to secure the advantages locally aggregated know-how regarding securitization can bring to a financial centre in addition to the income in form of taxes and wages from the trust sector¹⁸⁷. However, the regulatory exemption for SPE's in almost all countries under investigation, caused a lack of information about what was inside of these SPEs, once the crisis hit.

¹⁸⁶ Members of the EU, which joined in 2004 or later are excluded due to the lack of financial sophistication in these markets, which means that securitization activity is minimal.

¹⁸⁷ VIMS, the Dutch association of the trust sector, which includes the management of securitization SPE's has estimated that tax contributions alone, springing from the trust sector amount to Euro 3 billion. (s. <http://www.vims.nl/?pageID=81&languageID=2>, s. also Aalbers et al 2011b: 41)

The exclusion of special purpose entities for securitization from the scope of banking supervision, in particular the exclusion from the status of financial institutions has also very important ramifications for the second access point for the regulation of the ABCP-business, the consolidation of these conduits in the prudential perimeter of consolidation as I will show in the following.

7.5 Keeping regulatory charges off the ABCP business

Asked about the different regulations in the field of securitization in Europe and in Germany for special purpose entities for securitization, a German official replied:

Official: There are many access points to this problem: is it a financial service entity or is it not, I don't know what they ask them to consolidate, if they use the criteria of the majority of risks and rewards, or if they do included them as financial service providers, that is a difficult relationship, if you look at the German law of banking supervision on financial service providers, usually securitization entities are excluded ... in the field of consolidation, the international rules are relatively abstract...if you look at the banking directives, the questions of consolidation are not as differentiated as say the capital adequacy rules, ... and there you have latitude in the national conversion, and this one is used in this area. That means that you can find very many very different rules for consolidation ... now I am mostly talking about rules for consolidation for core capital requirements.” (translation M.T. interview Bundesbank 11.08.2010).

The remarks by this Bundesbank official, while difficult to understand at first sight, are very insightful for several reasons. They compare the degree of national leeway between the rules for consolidation and the rules for capital adequacy requirements in the Basel framework. Both of them together are used to calculate the core capital requirements, the former answering the question to which entities and assets the core capital requirements need to be applied, the latter answering the question how much core capital needs to be withheld for each asset. Whereas these latter rules are clearly laid out, the former rules regarding what needs to be

included in the prudential perimeter of consolidation are not. Therefore, you do have much more variation in the former than in the latter.¹⁸⁸

The question what needs to be consolidated in the balance sheet of a banking conglomerate in prudential terms is in fact a twofold question. The first part of the question is if an entity is consolidated in the balance sheet of the banking conglomerate in financial accounting terms. This is what the official refers to when he asks “if they use the criteria of the majority of risks and rewards”, because only a rule employing this criteria could force ABCP conduits on the balance sheets of their sponsors. The second question is, if the entity is consolidated in financial accounting terms, is it then deemed a banking activity such that it also needs to be consolidated for prudential reasons? Industrial entities owned by banks will be excluded from this prudential scope and only financial service providers will be included, which is what the official refers to when he asks “is it a financial service entity or is it not”? If an ABCP conduit is not deemed a financial service entity in Germany, it will not be included in the prudential scope of consolidation, even if it is included in the financial statement.¹⁸⁹ Concerns over competitive inequities and the possibility for the exclusion of certain activities from international banking regulation through national laws were the structural conditions for the regulatory race to the bottom for off-balance sheet securitization activities of banks. This competitiveness argument became even stronger with respect to the third entry point of regulation, the liquidity lines banking conglomerates granted to their ABCP-conduits.

¹⁸⁸ In the process of revision, the problem posed by the different nationally determined consolidated financial statements, forming the basis for the calculation of capital requirements is acknowledged.

“The Committee is aware that interactions between regulatory and accounting approaches at both the national and international level can have significant consequences for the comparability of the resulting measures of capital adequacy.” (BCBS 2004a:3)

However, the Basel committee had no means for correcting for it.

¹⁸⁹ As the official confirms, this is exactly the current situation in Germany, where ABCP conduits are included for the financial statement, but no core capital requirements are applied to the assets in it (s. e.g. Deutsche Bank 2010: p. 6 Available at https://www.deutsche-bank.de/ir/en/download/Basel_II_Pillar_3_Report_2010.pdf)

Regulatory frameworks for securitization in the US and other developed countries early on sought to limit the most blatant attempts of regulatory arbitrage, for example when banks transferred credits, but not the risk of default attached to them. Banks had to withhold core capital for letters of credit granted to securitization vehicles and other contractual obligations that effectively inhibited any risk-transfer from the banks to financial markets (s. Boemio and Edwards 1989). But liquidity support by the banks for SPEs of less than one year remained exempt from capital charges. As a reaction, these liquidity lines were structured to end after less than one year (364 days) in order to avoid core capital charges specified in Basel 1, but were renewed the day of their expiry. They were often tailored to supply the maximum credit enhancement possible to investors without being classified as credit enhancement (s. Moody's 1997, which documents liquidity lines, which were disguised credit enhancements to special purpose entities). Charging core capital to these lines, which were a clear example of regulatory arbitrage on a national level implied a level of regulation clearly stricter than international requirements. As a consequence, competitive inequity concerns led to large scale regulatory inaction on this level as well as on the level of prudential consolidation (s. table 2 below).

The piquant aspect of this development is that it occurred at a moment when the international regulatory community became increasingly aware of acts of regulatory arbitrage occurring in the field of securitization. Findings of regulatory arbitrage in the field of securitization were a major factor motivating the revision of the Basel accords. These debates which motivated the development of the securitization framework in Basel 2 should not be seen as completely external to national regulatory debates. Most of the countries I compare were members of the Basle Committee that debated this framework between 1998 and 2004 (Belgium, Canada, France, Germany, Italy, Netherlands, Spain, UK, USA). Regulators from these countries

therefore must have been aware of the international debates on acts of regulatory arbitrage in the field of securitization and proposed measures to remedy the situation.

7.6 Regulatory problems with securitization and the revision of the Basel Accord

Securitization as a financing technique received a boost from the new capital requirements installed by the first Basel Accord. Those countries which did not have a regulatory infrastructure in place in order to permit the transfer of bank assets from the balance sheet came under pressure by their domestic banks to achieve such a regulation, as was the case in Japan (Kapstein 1991: 28). This pressure stemmed from the cost advantages banks could achieve engaging in securitization. That banks used this field of activity to evade regulatory costs related to core capital requirements did not go unnoticed.

In 1995, the Bundesbank linked the six-fold growth of securitization from 1980 to 1995 to the reduced regulatory burdens in this field as compared to bank-credit, which created incentives for circumventing innovations (“Umgehungsinnovationen”, Bundesbank 1995: 21). The **first** working paper of the Basel Committee in 1999, went even further when it evaluated the impact of Basel on bank behaviour. The authors noted large scale and accelerating acts of regulatory arbitrage in the field of securitization. They find it to be most pronounced in the field of ABCP-conduits, where with the help of specific chains of securitization large scale capital relief is achieved, without changing the risk exposure of the bank (s. Jackson et al 1999: 24, Balthazar 2006: 33-35). The study of the BCBS in 1999 on US-banks shows the degree to which some financial institutions have become engaged in the ABCP and CLO market to gain

advantages from regulatory arbitrage¹⁹⁰ and indicates accelerating possibilities for such regulatory arbitrage (s. Jackson et al 1999: 25). Their conclusion is rather drastic:

“The available evidence suggests, therefore, that the volume of regulatory capital arbitrage is large and growing rapidly, especially among the largest banks. Securitisations are motivated by a number of factors But there are indications that in many cases the effect is to increase a bank’s apparent capital ratio relative to the riskiness of its actual book, which is making the ratios more difficult to interpret and in some cases less meaningful.” (ibid.: 26)

The fact that banks were hiding their true risk exposures with the help of securitization is clearly communicated. The existence of this report and its clear message suggests that the problem did not reside in the capacity of information gathering or understanding by regulators (regulatory ignorance), but instead in the quick action on behalf of national regulators to close these gaps.¹⁹¹

Indeed, the regulatory arbitrage occurring in the realm of securitization was one reason motivating the revision of the Basle Accord that started in 1998 (s. Blundell-Wignall and Atkinson 2010: 10, Balthazar 2006). One goal was to limit the shifting between on-balance sheet assets with different weights, and the shifting of assets off-balance sheet (s. Blundell-Wignall and Atkinson 2010: 10). On the other hand, the risk-weighting of securities with high credit ratings was seen as too high. Accordingly, the revised framework included a section on how to treat the risk exposure of banks towards securities (often lowering regulatory capital requirements), while also imposing capital requirements on liquidity lines from banks to

¹⁹⁰ “On the basis of the available information, the securitisation activities of these companies loom large in relation to their on-balance sheet exposures. As of March 1998, outstanding non-mortgage ABSs and ABCP issued by these institutions exceeded \$200 billion, or more than 12% (25%), on average, of the institutions’ total risk-weighted assets (loans). For several institutions, the combined issuance of ABSs and ABCP approached 25% (50%) of total risk-weighted assets (loans).” (Jackson et al 1999: 24)

¹⁹¹ The study also considered the question if Basel levelled the playing field for international banks. Here it cautioned that different accounting treatments prevent some of the levelling efforts (ibid: 41). These differing accounting treatments were a reason for the lack of containment of regulatory arbitrage in the field of securitization to lower capital requirements, as will be shown below.

securitization-SPEs with less than one year maturity (s. BCBS 2004a: pp.116-139), seeking to close the loophole used for regulatory arbitrage. The revised framework was developed from 1998 until July 2004, when it was published.

These international developments did not constrain regulators, instead they offered opportunities for stricter regulation if national banking regulators chose to implement them. Already in the second consultative paper published by the Basel Committee in January 2001 (s. BCBS 2001: 88) most of the final framework was developed. On the one hand, there were measures lowering capital requirements, such as the external ratings based approach to securitization exposures. On the other hand, measures such as capital charges for early amortization of revolving credit as well as proposed capital charges for liquidity lines below one year were already agreed upon in 2001. In the interim period from the first draft in 2001 to 01.01.2008, regulators had the choice to implement elements of the framework ahead of time according to domestic preferences. As will be seen, they did so more often lowering capital requirements for securitization rather than raising it.

7.7 The Abiding Hegemon

In November 2001, the US banking regulators lowered capital adequacy requirements for asset-backed securities and mortgage backed securities. In the new rule, they were introducing a new scale for the risk weighting of securitized assets held on the books of banking conglomerates, which was based on external ratings (s. Federal Register 2001: 59613-59667) similar to the standardized approach in the revised framework (s. BCBS 2004a: 122f). This rule change corrected for the high regulatory capital requirements imposed on highly graded securitized assets (Friedman and Kraus 2011 correctly identify this as one reason for the

increasing concentration of RMBS in the commercial banking sector, s. also Lall 2009: 20f). In their justification, the regulators point to the consultative paper of the BCBS in January 2001.

“In the international arena, the Basel Committee on Banking Supervision (of which the OCC, the Board, and the FDIC are members) issued a consultative paper entitled, “A New Capital Adequacy Framework” in January 2001, on possible revisions to the 1988 Basel Accord. The Basel Consultative Paper discusses potential modifications to the current capital standards, including the capital treatment of securitizations. The standards established by this final rule are consistent in many respects with the Basel Consultative Paper.

In particular, the use of external credit ratings issued by rating agencies as a basis for determining the credit quality and the resulting capital treatment of securitizations is consistent with the approach outlined by the Basel Committee.” (s. Federal Register 2001: 59613).¹⁹²

However, other measures that were part of the same consultative paper of the BCBS in 2001, which were increasing capital requirements were not implemented early on in the US. The case of capital requirements for issuers of credit card securitization is exemplary. On 8th of March 2000, the US banking regulators announced their intention to issue a rule which would raise capital requirements for banks selling asset backed securities based on credit card receivables to 20% of what it would be if the assets stayed on their balance sheet (s. Federal Register 2000: 12320). In November 2001, they reiterated their concerns that the early amortization rules effectively preclude an effective risk transfer, as investors get paid out before they are at risk of losing money due to default (s. Federal Register 2001: 59614). But while such provisions are proposed in the consultative paper (s. BCBS 2001: 88f), they did not pass a final rule, stating that the proposed rule was too risk-insensitive to the specifics of each single transaction (s. Federal Register 2004: 44913). In October 2003, the regulators issued another proposal for new rules (Federal Register 2003: 56568), which was based on the third consultative paper of the Basel Accord of 2003, more sophisticated in terms of measuring the risks.¹⁹³

¹⁹² Given that external ratings are especially prevalent in US financial markets and that the US financial system always had the largest volume of securitized assets outstanding, it seems likely that the US has worked extensively on producing the draft issue on securitization.

¹⁹³ “In the interim, the Basel Committee on Banking Supervision (Basel Committee) set forth a more risksensitive proposal that would assess capital against securitizations of revolving exposures with early amortization features

However, in July 2004, when the revised Basel-Accord was already passed containing the exact measures as proposed in the third consultative paper, the new rule on capital requirement for credit card receivables was not adopted. Their argument as to why it was not adopted quotes the concerns of five commenters that

“coordinating both the timing and the substance of an early amortization capital charge internationally would help **maintain a level playing field across countries** and would avoid requiring U.S. banking organizations to implement new capital rules, only to require them to implement slightly different rules in the future when the agencies implement the Basel changes.” (Federal Register 2004: 44913, emphasis mine)

Regulators agree to both points, and delay their decision until the Basle framework is transformed into US-rulemaking.

“At this time, the capital treatment of retail credit, including securitizations of revolving credits, may change as the revised Basel framework proceeds through the U.S. rulemaking process. Therefore, the ultimate treatment of securitizations of revolving credit exposures incorporating early amortization provisions is still uncertain. As a result, the agencies have decided that, at this time, it would not be appropriate to implement a risk-based capital charge for securitizations of revolving credits when the treatment may be revised with the implementation of the new Basel Accord.” (ibid)

In this case, prudence in the regulatory framework was of less concern than international competitiveness of the banks, even if the rules of the Basel Accord are already passed.¹⁹⁴ On the other hand, a rule, built on the first draft of the Basle Accord in 2001, lowering capital requirements was approved by the banking regulators, arguing that it was in line with the Basle Accord. The comparison suggests that the differentiating factor between these two cases is the presence or absence of level playing field concerns.

based on key indicators of risk, such as excess spread levels. The risk-based capital charge for early amortization proposed in the NPR was based on the proposal set forth by the Basel Committee in its third consultative paper issued in April 2003.” (Federal Register 2004: 49913)

¹⁹⁴The threat of a deviating implementation in the US, it seems, should be under control for the three regulators, given that Basel is passed and the new rules are equivalent to Basel.

In the same ruling of July 2004, the US-regulators were introducing a 10% credit conversion factor for liquidity lines with less than one year maturity. Initially they had proposed a 20% credit conversion factor, in accordance with the provisions proposed in the consultative paper (s. BCBS 2001: 88) and accepted in the final revised version of the Basle Accord (s. BCBS 2004a: 125 for the standard approach: 138 for the advanced approach). Which arguments convinced them to lower the capital charge for liquidity facilities?

“Seven commenters stated that the proposed 20 percent credit conversion factor for short-term liquidity facilities was too high given the low historical losses and the overall strength of the credit risk profiles of such liquidity facilities. Six of these seven commenters instead suggested that a conversion factor in the range of 5–10 percent would be more appropriate given banking organizations’ credit loss experience with short-term liquidity facilities. One commenter noted that the proposed capital charge would put U.S. banks at a competitive disadvantage relative to foreign banks and non-bank funding sources. The agencies generally agree with these commenters.” (Federal Register 2004: 44910).

US-regulators are deciding to apply capital requirements which are lower than the ones agreed in Basle, as these on the one hand seem to diverge from industry experiences (pointing to cognitive capture) and they would threaten the competitiveness of US banks.

The US would again acquiesce to its banks in the question of the application of core capital requirements to SPEs after new, sharper accounting rules had been introduced, setting off a cross border relative sequencing effect, where the decision of the hegemon USA to exempt its banks from such onerous requirements overdetermined the decisions of most European regulators.

7.8 The non-use of accounting information for regulation in the US and Europe

Any changes to accounting standards which could force ABCP-conduits on the balance sheet and therefore could lead to increasing capital requirements become charged with concerns over international competitiveness of the domestic financial sector. This specific concern over

competitiveness linked to accounting rule changes is specific to the financial sector and stems from the linkage between accounting numbers and prudential requirements, as a former standard setter in Canada and at the IASB explains:

“this is specific to financial institutions, what they call competitive disadvantage, really relates to the capital requirements and that flows from a strong linkage between what the accounting standards require and they use those numbers for their regulatory capital requirements ... there was a risk that your regulatory capital could be impacted and that could have a huge competitive effect, because of the multipliers that are in there” (interview London 22nd of February 2011, emphasis mine)

This direct coupling between accounting standards and banking regulation meant that if such a modernization occurred, it forced upon national banking regulators the question if capital charges should be applied to the newly consolidated assets from these subsidiaries. An affirmation to this question became more difficult, as foreign banks subject to more lenient accounting rules would gain a competitive advantage in the business of securitization as they had to withhold no core capital. Developments in the US, where regulators decided to exempt their banks from such onerous capital charges in 2003/2004 overdetermined the development of this debate in most European countries.

In the US, the sudden demise of Enron in 2001 led to a revision of accounting rules. In January 2003, the Financial Accounting Standards Board in the US issued a rule largely similar to SIC 12 (Fin 46, to be made more stringent in October 2003, FIN 46R). When Fin 46 came into force, it had an immediate effect on the ABCP market in the US, halting expansion and leading to massive restructuring of ABCP programs in order to avoid on-balance sheet consolidation (s. Bens and Monahan 2008: 1027). How did US- banking regulators react to these standards and the new on-balance sheet status of securitization SPEs?

In October 2003, the US banking regulators issued a temporary exemption of newly consolidated securitization SPEs from the calculation of core capital requirements, a decision which they made permanent in July 2004, with the Canadian banking regulator copying their measure (s. Bens and Monahan 2008). They argued that

“if no changes were made to regulatory capital standards, the resulting increase in the asset base would lower the tier 1 leverage and risk-based capital ratios of banking organizations that must consolidate the assets held in ABCP programs” and that such core capital requirements would “not appropriately reflect the risks faced by banking organizations involved with the programs. Sponsoring banking organizations generally face limited risk exposure to ABCP programs.” (Federal Register 2004: 44909).¹⁹⁵

The US banking regulators thereby created a loophole to drastically lower capital requirements for an activity equivalent to secured corporate lending. An industry observer explains the regulatory move as an attempt to circumvent international capital charges on corporate secured lending, perceived as too high, without abandoning the Basel Accord (s. Adelson 2003:6). The perception of the lack of risk stemming from ABCP activity was created for the Fed through data compiled by the American Securitization Forum on losses generated for banks through the provision of liquidity lines until 2003, which showed only very small losses (interview manager at the Federal Reserve, 03/08/2012). The problem with this data was the habit of banks to remove badly performing assets from the portfolio of ABCP conduits before liquidity lines were drawn (interview with a German banker active in securitization, 06/14/2011). In this respect, the Federal Reserve was cognitively captured by the industry due to their reliance on industry data. Their actions were likely also driven by competitive inequity concerns, as this

¹⁹⁵ Their ruling explicitly included structured investment vehicles and securities arbitrage programs (ibid).

topic is constantly on the agenda concerning changes in accounting standards (interview Federal Reserve manager, 03/08/2012¹⁹⁶).

The same issue arose for European Banking Supervisors with the transition of the European Banking System to the International Financial Reporting Standards in 2005. The Basel Committee Accounting taskforce as well as the Committee of European Banking Supervisors worked on developing “prudential filters” to deal with this transition to IFRS, the treatment of securitization SPEs being a minor point (background interview European Banking Authority, 03/09/2012). In December 2004 both bodies announced that capital charges for securitization shall be calculated according to the risk transfer framework of Basel, independent of the accounting treatment (s. BCBS 2004b, CEBS 2004). Substantially, this “prudential filter” corrects for the uneven playing field between the US GAAP and IFRS with respect to securitization, as it was more difficult to achieve deconsolidation of securitized assets from the balance sheets of banks under IFRS than it was under US GAAP (s. Adhikari and Betancourt 2008). This decision then is in line with the fact that level playing field concerns between the US and European countries are always an issue which is taken into considerations in the European context (background interview European Banking Authority, 03/09/2012). Neither of these guidelines was legally binding, but many European regulators used them to exempt conduits from capital requirements. Even if the securitization SPEs and their assets were consolidated in financial statements of banks, the financial supervisor could attest in an independent risk review that significant risk had been transferred and ignore these assets for the calculation of core capital. The securitization framework of Basel 2 here provided substantial leeway for national regulation, as fundamental concepts remained undefined. It was the task of the national regulator

¹⁹⁶ The interviewed manager joined the Federal Reserve Board in 2004, after the decision, but was informed about the process.

to define it in a regulatory dialogue with its banking institutions, as an official from the Bundesbank explained:

„The significant and effective risk transfer is mentioned in Basle 2, but not defined, nor is it defined in CRD 1 (Annex 9). It was thus left to the national standard setters to define the process.” (interview with Official Bundesbank 06/16/2011, s. also Enria and Texeira 2011:9).¹⁹⁷

Domestic preferences of banking regulators shaped these frameworks differently, but preferences favouring prudence had to overcome domestic opposition from banks and finance ministries, as was shown in chapter 4 for the case of France. As a consequence, ABCP conduits were in most European jurisdictions excluded for the calculation of core capital requirements, even if they were consolidated in the financial statements (background interview European Banking Authority, 03/09/2012). This holds for the UK, the Netherlands, Germany and Belgium, in addition to Canada and the US. Of the large Western European countries, only Spain, Portugal (s. Acharya and Schnabl 2010) deviated by continuing to base their decisions directly on IFRS accounting information. France, while decoupling the prudential treatment from the accounting treatment, maintained the possibility of applying capital charges to SPEs if the risks of it were deemed to reside with the sponsoring bank (interview former banking regulator, 01/30/2011).

¹⁹⁷ In general, including Basel 2.5 in 2008, the statements of the Basle Accord and their implementation in European Directives left a lot of policy space for national supervisors, in order to decide upon the national definition of things like “significant risk transfer”. (interview French banking manager responsible for accounting policies, Paris, 25.03.2011). Since Basel 3, parts of banking regulation are written as rules, rather than directives, leaving much less space for national discretion.

7.9 Correlations and causes of the variation in the regulatory regimes

In many European countries, we see even more leniency than in the US, reaching almost complete exemption. In the UK, the Netherlands, Germany, Italy and Belgium, authorities decided not to put any capital charges on liquidity lines before the coming into force of Basel 2 in 2008 for the large and sophisticated banks. This development is in line with the fact that in Europe, access for foreign banks to offer short-term securitization in domestic markets was easy and European directives guaranteed that banks could operate according to domestic rules. Furthermore, securitization was seen in the political scene as a way to diversify funding sources away from banking loans alone (s. Asmussen 2006).

The table below is comparing the different regulatory frameworks for securitization in Europe, the US and Canada according to two critical aspects of ABCP-regulation, the capital charge for liquidity lines of less than one year and the application of capital charges to consolidated SPEs. It links these features to the involvement of the banking regulator in accounting policies and to whom the banking regulator is subordinated.

	Power of national banking regulator over accounting policies	Banking regulator subordinated to central bank or finance ministry	Accounting policy and prudential regulation	Application of capital charges to the liquidity line with less than one year (credit conversion factor)
Spain	High	Central bank	Before 2005, Securitization SPEs were usually not captured in Spanish GAAP. Since 2005 strict link, non-permissive	2002: 100% (s. Acharya and Schnabl 2010); 2007/8 (with a 50% conversion factor, no 20%, s. circular 3/2008 de la Banco de Espana)
France	Medium since 1996, before high	Central bank	Fight over it, strict and non-permissive from 1999 until 2004 (under French GAAP for banks), in 2005, with the introduction of	2002 (20%)

	Power of national banking regulator over accounting policies	Banking regulator subordinated to central bank or finance ministry	Accounting policy and prudential regulation	Application of capital charges to the liquidity line with less than one year (credit conversion factor)
			IFRS the link is severed	
Netherlands	Weak, before 1996 medium	Central bank	Accounting policies not translated into prudential regulation since 1997	2007/8 (20%)
Germany	Weak	Finance ministry	Until 2009, Securitization SPEs were usually not captured in German GAAP, when they were from 2010, link was Severed	2007/8 (20%)
USA	Weak	Central bank	Until 2003 securitization SPEs were usually not captured, when FIN 46 is introduced, it is transposed into simple leverage ratio, but not for the calculation of capital requirements	2004 (10%)
Italy	Medium to High, the Banca d'Italy specifies the accounting standards to be applied in the technical forms to be submitted to it for prudential supervision, in compliance with resolutions of the Inter-Ministerial Committee on Credit and Savings (s. IMF 2004a: 69)	Central bank	Until 2004, Securitization SPEs were usually not captured in Italian GAAP, IFRS is introduced in 2005, link is severed in March 2006 (Schiavello and Mimun 2007)	2007/8 (20%)
Portugal	High (s. IMF 2007: 55)	Central bank	Before 2005, Securitization SPEs were usually not captured in Portuguese GAAP, Since 2005, strict use of consolidated SPEs for prudential regulation, non-permissive, s. Millenium BCP 2011: 9f)	2002: 100% 2007/8 (50%)
Canada	Medium, OFSI has the option of a regulatory override, but has not exercised that option).	Finance ministry	Very relaxed until 2004, when Accounting Standards Board Guideline 15	2004 (10%)

	Power of national banking regulator over accounting policies	Banking regulator subordinated to central bank or finance ministry	Accounting policy and prudential regulation	Application of capital charges to the liquidity line with less than one year (credit conversion factor)
	They cooperate with Canadian Standard Setter, who bound itself to FASB)		(AcG-15) is transposed into simple leverage ratio	
Belgium	No	Independent agency, since 2004 linked to Central bank	Until 2004, Securitization SPEs are not captured in Belgian GAAP. did apply significant risk transfer framework afterwards, only consolidating the equity of SPEs, as they are not banking institutions (s. Dexia 2009: 11)	2008 (20%)
UK	No	Officially independent, but board members appointed by the treasury	Relaxed before 2004, excluded from the calculation of core capital requirements according to FSA rules (s. RBS 2009:5)	2007/8 (20%), before 2008 0%, s. FSA 2001: 119)

Table 2.2 The question of consolidation for Regulatory Regime for Securitization SPEs and their linkages to banking conglomerates

(Sources: ECB 2001, Acharya and Schnabl 2010, Thiemann 2012, BDO 2011, Bank of England 2007: 60, Banco de Espana Circular 3/2008)

The countries under investigation can be sorted into three groups regarding the strictness of the regulatory regime. In the first group, international proposals are exceeded. In these countries the banking regulator is under the heading of the central bank and in charge of accounting rules for its banks (Spain, Portugal). France can be added, as it is a banking regulator under the heading of the central bank and it had been in charge of accounting rules for its banks until 2004. Spain and Portugal put a 100% conversion factor on liquidity lines in the early 2000s (s. Acharya and Schnabl 2010) and the French banking regulator chose to implement the 20% credit conversion factor on liquidity lines of less than one year from 2002 onwards (s. Commission Bancaire 2002).

The second group is the north-American component of the sample (US, Canada). There, some action occurs before 2007/8 in order to limit the regulatory arbitrage of the banks, but it is below what is agreed in the Basel 2 framework. In this group, the central bank is the banking regulator who does not itself set the accounting rules, but is in constant contact with the Accounting Standard Setter. It is important to keep in mind that the Canadian regulator was in an imitating role with respect to the US (s. Bens and Monahan 2008), such that it is possible to argue we really only measure the position of the hegemonic power at the time. But the fact that the US regulator is staying below international benchmarks, even if it initially seeks to install them is significant, as it shows the power of concerns over competitive inequities to moderate rule making.

In the third group, no regulation is imposed on the securitization sector before 2007/2008. In this group banking regulators do not entertain a link with their accounting standard setter and don't have the task to set accounting rules. They are either central banks (Netherlands, Belgium) or agencies under the domination by the finance ministry (Germany) or whose board is appointed by the finance ministry (UK). Italy is the outlier as the central bank is the regulator, and it is partially in charge of the accounting rules, but the securitization framework (specified in the law 130/99) ignores the question of consolidation of SPEs. But this deviation might be the exception which justifies the rule as three related factors might have hindered more stringent regulations. First, the Banca de Italia is bound in its interventions in accounting standards by resolutions of the Interministerial Committee for Credit and Savings, chaired by the ministry of finance. Second, the small size of short-term securitization activity of Italian banks (there is only one ABCP conduit sponsored by an Italian bank¹⁹⁸) reduced the urgency of the problem. Lastly, Italy

¹⁹⁸ Sponsored by Intesa Sanpaolo from March 2002 onwards, the conduit Romulus never exceeded 2 billion dollars.

started a pro-securitization campaign in 1999, where stringent regulatory requirements might have been seen as counter-productive (s. Deacon 2004: 316).¹⁹⁹

The position of prudential regulators in national accounting standard setting networks has been proposed as a key explanatory variable explaining the variation of national accounting rules for securitization-SPEs and their use for prudential regulation for the cases of Spain, France, Germany and the Netherlands in the last two chapter . This table seems to confirm the hypothesis that the proximity of the banking regulator to the accounting standard setting process is correlated to the introduction of progressive accounting rules forcing SPEs on the balance sheet of their sponsors and its use for prudential regulation. There is also a correlation to the imposition of core capital charges on liquidity lines of less than one year, where only those countries whose banking regulators were also involved in accounting standard setting and their enforcement have introduced core capital charges on liquidity lines which are in line with the charges envisioned in Basel 2 or exceed it. The last two chapters have suggested a mechanism for this correlation. The different role of banking regulators in the field of accounting standards and enforcement meant that some banking regulators would be directly confronted with the problematic of regulatory circumvention in the field of ABCP conduits, whereas others remained rather distant to this issue, easier to be convinced by domestic banks of the legitimacy of the business and the threat of competitive disadvantages.

The correlations in the table furthermore point to the supportive role of finance ministries for securitization. In all of the countries where the finance ministry has a direct influence do we see the maximum delay in the closure of regulatory loopholes (the third group). This delay is in line with the French and German experience, where the finance ministry evaluated the

¹⁹⁹This campaign had the effect that Italy became the second largest market for true sale securitization in Europe from 2001 onwards (Deacon 2004: 316).

securitization technique as beneficial to expand credit and an important field of banking activity in the future (interview banking regulator France, 02/03/2012, interview German banking regulator 07/01/2011). The case of Germany is exemplary here. The concern over the profitability of German banks at the finance ministry over-determined regulatory inaction regarding the closure of regulatory loopholes, as the banking regulator was subordinated to the ministry of finance (interview regulatory advisor big auditing company, Germany 07/13/2011, interview German financial regulator 07/01/2011). In addition, there was intense international competition in the German ABCP market, where Dutch and American banks were very active (interview German banker 06/14/2011²⁰⁰). This competition endangered the goal to deepen the value-chain in German financial services, which was one of the two goals of the ministry of finance in its pro-securitization campaign (s. Asmussen 2006: 1016).²⁰¹ This regulatory permissiveness with respect to ABCP conduits was additionally supported by the problems the expansion of the Basel Accord to all banks in Europe and almost all banks in the US had created for the funding of SME's.

When the first Basle Accord was designed, it was supposed to apply only to internationally active banks. This scope had two reasons: only internationally active banks were posing a threat to non-domestic financial markets and only internationally active banks were in direct competition. In accordance with this initial goal, Japan only applied the regulations to those banks with branches outside of the home country. In the US the FED, the OCC and the FDIC however agreed to apply the Accord to all institutions they supervise, extending the coverage to almost all banks, reflecting commonly shared concerns over declining capital ratios

²⁰⁰ One example for the transnational competition is the multiseller ABCP conduit Erasmus of the Dutch bank Rabobank was incorporating 35 originators in eight countries in 2006 (s. http://www.rabobank.com/content/images/Rabobank_Debt_Capital.pdf).

²⁰¹ The other goal being the the promotion of cheaper sources of funding for SMEs.

in the US since the early 80s (Tarullo 2008: 38f). The coverage of the Basle Accord was even more complete in the European Union, where it was enshrined in European Community law with the Council Directive 89/647/EEC on solvency ratios for all credit institutions and the Council Directive 92/30/EEC on the supervision of credit institutions on a consolidated basis.²⁰² Basel imposed an 8% capital charge on these loans due to a 100% risk-weighting, although they were secured with collateral and therefore less risky than unsecured loans. These high capital requirements for loans²⁰³ threatened especially the credit supply for small and medium sized enterprises (s. OECD 2006: 47, Ayadi 2005: 31). From 1992 onwards, all banks in Europe and in the US had to hold higher regulatory capital against loans to this segment, which meant that banks had to charge higher interest rates to be profitable (Kapstein 1991:29, Ayadi 2005).

National financial systems could accommodate the funding needs of SMEs via new channels, e.g. via bonds for small and medium sized enterprises or off-balance sheet financing such as leasing. Off-balance sheet ABCP-programs of banks, which are structurally equivalent to secured lending (s. Adelson 2003: 6) were an alternative to the expensive credit supply via on-balance sheet financing, increasing the incentives for national banking regulators and finance ministries to support such off-balance sheet activities of their banks. Given the importance of Small and Medium Sized Enterprises for employment and economic growth, this issue posed problems to all countries. However, these problems were of varying magnitude according to the importance of SMEs for the economy as a whole and the percentage of external financing needed by this segment of the economy.

²⁰² This decision continued the policy of European wide capital ratios already enshrined in EEC directives since 1977 (albeit, back then for mere observational purposes, s. Tarullo 2008: 39) and is in line with the goal of a harmonized European financial system. In addition, large banks might have exerted pressure to have a domestic level playing field with respect to smaller banks.

²⁰³ With exception of those collateralized by cash.

Size by turnover (millions)	Austria	Belgium	France	Germany	Italy	Portugal	Spain
Less than €7m	13	40	34	14	26	31	42
Between €7m and €40m	27	38	35	22	25	40	43
€40m and more	31	39	35	31	28	51	37
All sizes	28	39	35	30	27	42	38

Table 7.3: Share of equity in the total balance sheet by enterprise size (Ayadi 2005: 14)

For countries, such as Austria, Germany and Italy, the equity share in SME's has been sub-average, implying larger need for external financing and greater risk weightings for the banking conglomerates lending to them. This has been an issue of such great economic importance that chancellor Schroeder intervened in the last moment of negotiations over Basel II in 2003 to change the risk-weighting formula for credits assigned to small and medium sized enterprises, as these threatened to be severely punished by the lack of sophisticated external ratings for this market segment (s. Barr and Miller 2006: 25, 37f). He was joined by Italy and Japan and in this last minute effort managed to install some advantageous changes to the risk weighting for SMEs in the new Basel Accord.

In the same year in Germany, policy action to increase the size of the ABCP market for German SMEs started, as SMEs were struggling with problems of access to banking credit since Basel 1 (s. Reich 2007, Hartmann and Schwartzhaupt 2007, Asmussen 2006).

The problems which the Basel framework created for the German financing model meant that German politicians would be particularly receptive to the pro-securitization lobby constituted by bankers and regulatory advisors (s. chapter 4). Future work should seek to verify if financing conditions for small and medium sized enterprises were also a factor for reform in favour of securitization in countries such as Italy and Austria, which both have permissive securitization frameworks. If these concerns were found to be a factor motivating regulatory

decisions, another structural reason created by the Basel Accords would be identified favouring the lax regulation of short-term securitization. These arguments over structural constraints favouring the shadow banking system stand in contrast to the common main-stream analyses which have sought to explain the growth of the shadow banking system before the crisis. While the argument of regulatory capture should not be rejected out of hand, there are different policy implications stemming from such an analysis as compared to a structural argument. These differences will be spelled out in the following.

7.10 Regulatory capture versus structural constraints of regulators

Attacking the Basel Accords as insufficient and a main culprit for the magnitude of the financial crisis is a common argument in the literature. However, the argument that I am making, that competitive inequity concerns, which the Basel Accord sought to overcome re-emerged at the margins of the Accord and constrained regulators in the regulation of securitization activities of their domestic banks is new. It challenges much of the International Political Economy literature on financial regulation and the financial crisis. This literature has focused on the regulatory capture of banking regulators and the lenient construction of the revised Basel Accord itself to explain the recent calamity (s. inter alia Mattli and Woods 2009: ix, Claessens and Underhill 2010: 114, Goldin and Vogel, 2010: 13, Lall 2009, 2012). In particular the introduction of the internal ratings based approach into the Basel 2 framework is taken as a sign of the dominance of large international banks in the rule-making process. It is true that one main goal of the revision of the Basel Accords was a reduction in capital requirements and that the internal ratings based approach, allowing banks to calculate the risk weighted capital requirements based on their own models often meant a reduction in core capital.

What these authors underemphasize, is the crucial role the shadow banking sector played in the crisis and the coming into force of the revised Basel framework by January 1st 2008 for the large and sophisticated banks (the advanced internal ratings based approach). The financial crisis began in spring 2007, with the announcement of losses of HSBC on a subprime portfolio and the failure of 2 hedge funds of Bear Stearns in June 2007. The revised framework can therefore only be seen as an accelerator of the financial crisis, but not as a cause of it (s. also Friedman and Kraus 2011: 170). Furthermore, in dealing with the links between the shadow banking sector and the banks, the revised framework represented advancement, if sometimes only marginal over the rules in Basel 1.²⁰⁴ What deserves more scrutiny is the long delay in the introduction of the revised framework and the lack of national initiative before 2007 or 2008 respectively in fields where regulatory arbitrage was clearly identified.

In a more nuanced analysis, Friedman and Kraus (2011) blame the Basel Accords for creating incentives for banking conglomerates to increase their holding of highly rated securities through their capital requirements. They see the ignorance of banking regulators concerning the interaction of different rules to concentrate risk in the banking sector as the fundamental cause of the crisis. However, this account underemphasizes the regulatory arbitrage by banks and overemphasizes the role of ignorance (lack of awareness) of regulators. In contrast, this paper problematizes the awareness of regulatory arbitrage in the shadow banking sector by the regulators and the lack of action about it (for a similar, more general critique regarding the run-up to the financial crisis, s. Stiglitz 2011). This lack of action, however, did not primarily stem

²⁰⁴ Most importantly the new framework envisioned a capital charge on liquidity lines of less than one year, with a conversion factor of 20%, whereas beforehand such liquidity lines did not face any capital charges. However, those banks which fell victim to their large exposure to the ABCP market in summer of 2007, such as IKB and Sachsen LB might not have been approved for such an advanced approach. Even if, the new measures of Basel were always better than no capital charge, as in the Basel 1 framework.

from regulatory capture of the regulators by the banks, but from the alignment of interest of banking regulators and banks in the national regulation of a global market.

Seeking to explain the lack of regulation of the shadow banking sector, the literature has focused on the argument of cognitive capture of the regulators by the regulated (s. Buiter 2008:601, Bhidé 2011: 105) or “cognitive closure” (Aalbers et al 2011: 1790), arguing that regulators were evaluating the risks of the sector with the help of the same concepts and numbers bankers did. Analysts of the evolution of different national regulatory regimes for securitization have pointed to the need for positive state action in the fiscal, legal, and accounting realm to permit securitization to migrate from one national framework to another and have emphasized the role market insiders played in guiding it (s. Aalbers et al 2011a: 1073, Wainwright 2009). The findings of my research suggest that a necessary condition for such cognitive closure was the lack of duties of the regulators in the formulation or enforcement of accounting policies for the banks. The findings regarding the correlation of varying stringency of regulation of the two most salient domains of regulation for ABCP conduits in different countries and specific constellations of banking regulators suggests that cognitive closure did indeed play a role in the way the policy process developed. A necessary condition for the avoidance of cognitive closure with respect to securitization seems to be the direct involvement of the banking regulator with accounting standard setting and their enforcement. But even when the regulators were fully aware of the degree of regulatory arbitrage and opposed it (as in the case of France), the banking regulator still had to overcome domestic opposition of banks and the finance ministry, created by competitive inequity concerns for a domestic industry in a global market.

These pressures emanating from the national regulation of global markets explain why regulatory action to close these loopholes has been mostly absent before the crisis. Although it

was known to the international regulatory community at least since 1999 that regulatory arbitrage was rampant in the securitization business (s. Jackson et al 1999), most national regulators were waiting for the new Basle Accord to come into force, rather than taking decisive steps nationally beforehand. The problem of coordination regarding the coinstantaneous introduction of rules closing the regulatory loopholes in a global market regulated through national rules in conjunction with the support of the competitiveness of national banks by national authorities explains the late introduction by many regulators of measures envisioned in the Basle process to close regulatory loopholes, while other measures to reduce capital requirements for securitization were introduced ahead of time. This fact reinforces the need for new institutions coordinating global regulation “where inadequate regulation in one country has large effects on other countries ... because of an induced race to the bottom” (Stiglitz et al. 2010: 110).

Accounting frameworks and scopes of consolidation remain different around the globe, with IFRS and US GAAP still diverging in their standards for consolidated balance sheets (s. Financial Stability Board 2011). If these different scopes of consolidation persist, there will be continued pressure on national banking regulators to reduce the scope of their prudential perimeter of supervision or to allow their banks in other ways to compete. As recent regulatory initiatives have increased core capital requirements for banking activity (esp. Basel III, s. Blundell-Wignall and Atkinson 2010: p. 23), this pressure for national exclusion will increase accordingly. If these structural conditions at the margins of banking regulation persist, national regulatory permissiveness of global shadow banking that permits the evasion of core capital requirements will continue to be a persistent feature of the regulatory landscape, sowing the seeds of a future crisis.

It is at this point that policy action is needed, and where different arguments over the causes of the growth of the shadow banking sector matter. The argument of regulatory capture implies that regulators could have acted forcefully if they just had the right disposition and that what is needed is to remove regulators from the close embrace of banks in order to sharpen their perception of risks to the public. This policy advice has its merits, but it is insufficient because it rests on the social-psychological level. If the structure of global financial markets, which are nationally regulated, forces regulators to endanger the profitability of their domestic industries without being able to inhibit an activity on their national ground, the social-psychological level is secondary. Instead, what is needed is to remove the obstacles to regulatory capacities inherent in the current set-up of financial markets. Structural reform is needed to ensure that obstacles to cooperation do not “weigh down the capacity of the regulatory policy makers to keep up with market innovation” (Underhill 1997: 20).

In this respect, policy makers could borrow an organizational feature from the International Accounting Standards Board, the Standards Interpretation Committee, developed to intervene immediately if the application of accounting rules steers into the wrong direction. An International Banking Regulatory Rule Interpretation Committee could translate the insights of research on regulatory arbitrage which is accumulating in the research departments of banking supervisors into immediate regulatory action. It is evident that the magnitude of the crisis could have been reduced if the existing rules had been implemented earlier. The delay of the implementation of the revised Basel Accord for the large and sophisticated banks to January 2008 also holds another lesson for policy makers. While it might be worthwhile to fine-tune regulatory measures in order to appropriately reflect the risks banks are taking, one should do so only after coarse measures are installed which serve as a first approximation to the problem. The

new framework envisioned in its basic approach a capital charge on liquidity lines of less than one year based on a conversion factor of 20%. For those German banks which fell victim to their large exposure to the ABCP market in summer of 2007, IKB and Sachsen LB, such a core capital charge might have destroyed their business model, as much of the fees were generated by the billions of dollars in liquidity lines they had granted to their SPEs. If these rules had been in place in 2007, they would have been most likely forced to reduce these liquidity lines, which could have saved them from bankruptcy.

Chapter 8: CONCLUSION

The recent financial crisis has been a negative externality of historic proportions, rivaling the Great Depression in the amount of public expenditure needed to repair damages to the financial system. The crisis had many causes, an important one among them was the lack of proper accounting for the risks the banks were taking. There is a view which emphasizes the novelty and complexity of the new securitized products which the banks had owned prior to the crisis to explain their negative impact (s. e.g. MacKenzie 2011). In contrast, this dissertation has emphasized the acts of balance sheet manipulation the accountants of banks and consultants from the large auditing networks engaged in prior to the crisis, downplaying the risks and expanding current profits of banks.

This dissertation had two goals. On the one hand it sought to understand what accounts for the rise of the bank-based shadow banking sector before the financial crisis, an unregulated part of the financial sector based on regulatory circumvention. Given that the banking sector to which it is linked is extensively regulated and supervised, the question I asked was if banking regulators did not understand the risks these financial institutions posed to the financial system or if there were other reasons for this gap in supervision? The second, related goal was based on the answer to the first question, to develop recommendations for how to regulate the shadow banking system in the future. To accomplish the first goal, I used the comparative method, exploiting the variation in the growth of the ABCP-market in developed European countries to identify four cases, in which the different volumes of the market suggested that these different countries had more lenient or more stringent regulation. Tracing the process which led to these different regulations, and comparing the processes between the countries, I sought to understand

the configurations of the regulatory regimes and the different actors in it which could account for this difference. Given that the infrastructure of this market is based on off-balance sheet decision for the special purpose entities that issue commercial papers, I decided to focus predominantly on the evolution of the accounting rules concerning the on- vs. off-balance sheet decision for subsidiaries in consolidated financial statements, and the role banking regulators played in its modernization. In order to force these SPEs, structured to avoid their recording on banks' balance sheet onto these balance sheets, the balance of power between auditors and audited needed to shift to provide the auditor with the capacity to question the structuring practices of his clients.

8.1 What have we learned?

Chapter four presented an account of this arena of conflict, in which structurally the audited have an advantage, aided by a large pool of regulatory consultants. The inclusion of auditor-consultants as members of the accounting team of the bank has shifted the conversation of banks with their auditor proper in favor of the bank in terms of the desired accounting decisions (cf. Coffee 2006). I show how principles rather than rules-based accounting standards might intervene in this conversation and strengthen the negotiation power of the auditors. However, even principles based standards, which redirect the decision making power from “objective” decision criteria to the professional judgment of the auditor cannot overcome the structural fact of the dependency of the auditor on the audited and the need for consent between the two. This fact tilts the balance towards the off-balance sheet decision, and it takes the forceful and knowledgeable intervention of a state regulator to counter this tendency.

The fifth chapter detailed the struggle over the introduction of principles based accounting standards in my four cases, which would provide auditors and regulators with the means to force these shadow banks back on the balance sheets of banks which sponsored them. I show that banking conglomerates and other corporations intervened forcefully to prevent the introduction of these standards, as these threatened their profitability and that the intervention of banking regulators in the standards setting process could overcome this blockage. In how far banking regulators were involved in accounting regulation for banking conglomerates has shifted in a quick pace over the course of the last 40 years in the cases under investigation, due to transnational developments in accounting and banking regulation. These shifting positions had an important impact on the question if the banking regulator was involved in standard setting and if the information generated by a SIC 12-like rule, once introduced into domestic GAAP, would be used for core capital requirements.

The professionalization and transnationalization of accounting standard setting (International Accounting Standards) challenged the capacity of banking regulators to maintain a voice in the standard setting process, with the Dutch Central Bank losing its influence, while the French and Spanish maintained it. The German banking regulator, at a critical juncture of institution building for accounting standard setting (1998) was excluded in favour of convergence with the International Accounting Standards body. Even if the banking regulator maintained a voice in the standard setting process, he had to overcome strong resistance to these accounting rule changes (let the reader be reminded of the power struggle between the French finance ministry and the banking regulator over how strict these rules should be).

In the sixth chapter I investigated the struggles over the interpretation of SIC 12 and SIC 12-like rules in the four different countries. I show that absent an effective monitoring and enforcement

apparatus, this standard was prone to failure and that banking regulators could play a decisive role in shaping these interpretations. Regarding the different stances of the banking regulators towards SIC 12-like rules and their interpretation, I argue that these are linked to their domestic position in the regulatory risk regime of accounting. Only if they were capable of gathering independent information and were monitoring the business activities of their banks actively with respect to their representation in accounting, did they develop a negative stance towards ABCP conduits. If regulators left the question of on- and off-balance sheet status for these “shadow banks” to be decided by auditors, the structural power of the audited could prevail. In contrast, in the cases of Spain and France, the on- or off-balance sheet decision of auditors was tested and if seen as necessary revoked by the banking regulator. This capacity also allowed them to impose a more prudent interpretation of this accounting standard. The analysis of the French regulatory network over how to interpret their SIC 12 like standard reveals in this respect even a more far reaching attempt. The French regulators sought to impose a country-specific prudent interpretation of the international SIC 12, once it was introduced. Their capabilities and legal responsibilities in the field of accounting as well as their collaboration with the auditing networks are identified as the crucial differentiating variables which enable this national power within a supposedly transnational field.

These two chapters allow a first answer to the central question of my dissertation: Were the risks of this shadow banking sector unbeknown to banking regulators and if so, what were the conditions for this ignorance? They persistently show that if banking regulators have accounting capabilities, they are opposed to the abuse of off-balance sheet financing, pushing for the “prudent” demarcation of their banking conglomerates. Banking regulators, whose accounting capabilities are cut off or never develop don’t actively use accounting to steer the

behaviour of their banks. Nevertheless, they rely on accounting information for their regulatory activity. They are not aware of the concerns of auditors and instead agree with financial engineers and the banks that seek capital relief for off-balance sheet entities.

This function of banking regulators, to set accounting standards for their banks and to enforce them is endangered by the transnational pressures in the field of accounting, where international standard setting does not envision a prominent role for the banking regulator in standard setting or enforcement. The growth of autonomy of (international) accounting from local contexts can be seen as a direct outcome of “functional differentiation, where the growth of transnational business demanded within accounting a further specialization in methods and individuals that could operate with ease across languages and countries” (Eaton and Porter 2008: 132). But this functional differentiation and transnationalization endangers the capacity of banking regulators to steer the behaviour of their banking conglomerates. The regulatory relationship between the two is partially defined by the accounting numbers, which generate the object of regulation (banking conglomerate). This study suggests that banking regulators need to follow a holistic approach to regulation, which does not only include the application of rules to certain data material but also the control of the construction of that data material itself. This conflict between functional differentiation of a subsystem (accounting) on the one hand and its potentially negative interaction with other systems (banking regulation) due to interdependencies between the systems has been problematized already by Luhmann (1984, quoted in Eaton and Porter 2008: 140). How to resolve it should become a major issue for future regulatory reform. There are many different options, e.g. establishing a special accounting regime for banking conglomerates globally or including the concerns of banking regulators in standard setting on the transnational level and involving national regulators in domestic enforcement of accounting rules

for banks. However, to weigh the advantages and disadvantages of these different options is the task of future work. This study can only raise this issue but not answer it.

This is not the only transnational challenge which impacted the regulation of the ABCP sector. Chapter seven provided yet a different angle to the question if the risks were unbeknown to banking regulators or if there were other, more structural reasons which account for the gap in banking supervision. It recasts the regulation of the ABCP conduits as the national regulation of a global market, in which banks compete globally according to national rules. It argues that the under-inclusiveness of the Basel Accords, which sought to erase competitive inequities for globally active banks led to the re-emergence of these concerns at its margins, the bank-based shadow banking system. The Basel Accords prescribe the supervision of banking conglomerates on the basis of consolidated financial statements. However, they do not prescribe a common global standard for how such consolidated balance sheets shall be produced, which provides competitive advantages to banks with more lenient accounting rules. This limits the action of banking regulators in this field due to concerns over the competitiveness of their domestic banks. This, I argue explains the large degree of inaction of many banking regulators before the crisis with respect to the bank-based shadow banking sector.

The ABCP market has been described as problematic and driven by regulatory arbitrage of banks by the Basle Committee (the international body of banking regulators, in which France, Spain, Germany and the Netherlands are active members) in 1999. The reform process of the Basle Accord from Basle 1 to Basle 2 that started in the same year was motivated partly by the attempt to reduce incentives for regulatory arbitrage. However, while the diagnosis of the problem occurred on the international level in 1999, in most of the national legislations investigated, regulation to reduce regulatory arbitrage was not taken until 2008, the date of

introduction of Basle 2. The measures in Basle 2 addressing regulatory arbitrage, however, were completed in 2003 and adopted in 2004. How can this long period of inaction be explained? Some authors have related this pro-shadow banking stance of banking regulators to cognitive capture (due to economic theories legitimizing them) or cognitive closure (all dialogues occur only between banks and regulators, all data to evaluate shadow banks is provided by banks). I introduce a third factor, which has not received sufficient attention, the dimension of “level playing field concerns” shared by regulators and the regulated. I show that national banking conglomerates were lobbying against any rule changes which would increase their regulatory costs on these shadow banks with respect to their foreign competitors. Regulators did consider these concerns of competitive inequities in their rule making, as domestic banks faced competition in securitization on domestic soil. This event shaped the transnational dynamics of ABCP regulation. When in 2003 US and Canadian GAAP became stricter in its off-balance sheet criteria after Enron, the two banking regulators relieved the ABCP sector from having to account for the conduits which were coming on-balance sheet with core capital, following “level playing field” arguments of their banks. In December 2004, the Committee of European banking supervisors refused to switch to a more stringent regime of supervision of ABCP conduits, made possible by the introduction of principles based accounting standards for SPEs, following their American counterparts, due to fears of competitive inequities and convincing data by the industry. Regulatory inaction before the crisis can thus largely be traced back to the divergence between the level at which the problem posed itself (global) and the level of possible action (national).

8.2 The implications of my case for the debate on the regulatory state in globalization

The seventh chapter and the French revision of accounting rules due to fears of competitiveness despite the opposition of the banking regulator detailed in chapter five clarify that regulatory capture is insufficient to explain the regulatory permissiveness before the crisis. The argument of regulatory capture situates the problem on the psychological level or at the most at the level of formal and informal relations of the regulators with the regulated and the question of the division of labour in terms of monitoring and information gathering. This perspective needs to be supplemented with an emphasis on the structural conditions under which regulators do operate. In this respect, one can argue that what regulators did with respect to the ABCP segment of the shadow banking system was just a logical reaction to the situation they were facing. The home country rule of supervision regarding the solvency of banks, established by the first Basel Concordat in 1975 (Herring 2007: 202) was the decisive structural impediment for domestic regulators. The agreement to apply this principle in the European Union and between the EU and the US, in conjunction with the mutual acceptance of domestic banking regulation on foreign soil implied that domestic banking regulators had no capacity to stop these transactions occurring in their territory, the only thing they could do was to regulate their own banks out of this market. To impose costly regulation meant to make domestic banks uncompetitive, not to stop the business in its entirety. In this respect, the current debate about regulatory capture carries some similarities with a situation, where one is blaming the guardian for not protecting the house from burglars while conveniently ignoring the fact that everybody beforehand to disarm the guardians. Regulators in their decision-making are also partially reflecting the competitive realities which are imposed upon them by international agreements.

As banking regulators lacked the capacity to limit market access for the ABCP market, and heterogeneous process regulations conferred competitive advantages upon certain national banking conglomerates, we have a quasi-ideal-typic situation for the theory of regulatory laxity for production processes which Murphy has developed (s. Murphy 2004). The national regulation of international markets leads to effects which directly challenge the realist predictions of international relations scholar who claim that even under the situation of increasing transnational economic transactions, large powers continue to shape regulatory regimes (Drezner 2007, Simmons 2004). The central pillar of their argument, that the size of domestic markets can be used by these powers as a club to enforce more stringent regulation does not work, as is demonstrated by the case of the US. Even there the competitiveness argument changed domestic regulatory preferences. The national regulation of globally active businesses is weakening the regulatory autonomy of nation states, if market access cannot be limited. Unless this capacity for domestic regulators is reinstated, the regulatory downward trend in finance will continue. The case of the bank-based shadow banking system is particularly powerful in this respect, because it is at the margins of the comprehensive international banking agreement that it occurs. No nation state has violated international agreements by permitting lax regulation of this part of the shadow banking system, thus the call of foul-play of other nations doesn't apply. What is important about this location at the margins is that these margins will always exist, as no regulation can be completely comprehensive. These margins of regulation, as I showed for the case of accounting for ABCP conduits are the prime site for the labour of regulatory circumvention. Finance as a dynamic system is structuring itself around these margins, as regulatory circumvention is providing a cost-advantage over regulated competitors. This dynamic of regulatory circumvention at the margins of banking regulations, which occurs

on a global level is confronted with national responses. In this process, one will by default get a heterogeneous regulation of production processes. But once these decisions are made nationally, they shape the debate in other nations about the global competitiveness of the domestic banking industry in a global market.

My dissertation suggests that one source for the heterogeneous regulatory treatment for financial innovations at the margins of global agreements are these global agreements themselves and the frictions they create for national political economies. A global accord, such as the Basel regulations, will most likely create frictions at the national level, as global agreements can hardly take into account all national peculiarities. Those who suffer from these frictions coalesce domestically with those who (would) benefit from the evasion of comprehensive banking regulation, due to a reduction of production costs for their services to push for a certain regulatory stance. The Basel agreements number 1 and 2 threatened in particular the credit supply to SMEs and ABCP conduits were seen as a substitute for bank credit to this sector of the economy. In countries, such as Germany, where SMEs are seen as vitally important, these frictions are perceived as more important than in countries such as France, where large corporations dominate which have easy access to financial markets on their own. The varieties of capitalism literature (cf. Hall and Soskice 2001) might be helpful to understand these frictions emerging from global agreements and the way these frictions translate into regulatory action. In the case of Germany, we have a corporatist policy network, whereas Spain and France are described as members of the statist variety, where the state has a greater degree of autonomy in the decision making. To this comparative literature, we need to add the concern over profitability of the banking system which becomes particularly urgent when direct competition is introduced in the European banking system in 1990. The lax regulation of the ABCP market in the

Netherlands and Germany is an expression of these concerns, as low profitability (Germany) and limited domestic markets (Netherlands) made the financial innovation of ABCP conduits look particularly appealing.

The argument for increasing the global competitiveness of a domestic industry is in this case an argument for an industrial policy which rests upon regulatory laxity. It has specific appeal in an industry which is trading legal constructs because there are significant reductions in transaction costs which can be achieved if knowledge is concentrated in one place and the number of transactions can be increased. Transaction costs and regulatory costs are the two major cost components in this business, which means that establishing a regulatory environment conducive to certain transactions will over time reduce transaction costs and thereby further increase the competitiveness of the domestic industry. The concentration of knowledge in one locale brings with it the concentration of high-income professionals (lawyers, bankers, regulatory advisors, auditors), who spend and pay taxes and corporate investments. This makes support for “cutting edge” financial innovations very attractive for local and national politicians.

8.3 The question of generalizability

As Smelser (1976: 242) has pointed out, a big problem of causal inference is the assumption that one can keep other variables of influence constant, assuming parametric rigidity, where in historical case studies this can hardly ever be achieved. What is the population to which we can actually apply the knowledge we have gained from these few cases? I have deliberately limited my in-depth case study to the European Union, and here to continental Europe, focusing on countries with a code law rather than case law tradition. The results thus gained therefore might need some adaptation to reflect regulatory realities in Anglo-Saxon countries. However,

the detected differences in regulatory styles and supervision in my cases and its correlated effect on the growth of the ABCP market strongly suggest that the mechanisms of keeping control over potentially harmful financial innovations also apply in other countries. This study suggests that regulators need to engage in a constant critical dialogue with the regulated over the purpose of a financial innovation and exercise their judgment and discretion. Financial innovations for regulatory circumvention are stitched on the edge of existing regulation, seeking to fall outside the realm of what is regulated. These dialogues can be very helpful in order to gain a view of the economic substance of these constructs, rather than their mere legal form. To gain this understanding, regulators should not limit their interlocutors to bankers alone, but include lawyers, auditors and regulatory advisors. As the construction of these financial innovations does not only involve bankers, but also regulatory advisors, lawyers and auditing companies, these are carriers of important knowledge regarding the purpose of these constructs. In these dialogues, it is impossible for the regulated to answer that an innovation occurs for reasons of regulatory circumvention, which will force them to find other supposed reasons. Critical dialogues will bring to light these paltry excuses and allow the regulator to constrain such constructs. They need to be given the legal capacity to challenge these constructs and to impose their more prudent view on the actions of the regulated.

The second question, besides the generalizability in space to other jurisdictions and other financial innovations, concerns the generalizability of these findings in time, and here in particular for the future. If we were to face a significant deceleration of financial globalization (in terms of financial innovation and increasing degree of transnational operations) or a significant empowering of nation states with respect financial innovations (as suggested by Germain 2010), the results of chapter five concerning regulatory styles and ways of intervention

might become more important, given that the national arena would gain in importance. However, if decision making on regulatory matters is transferred to the EU-level, the studied regulatory dialogues will be shifted to a new level, with a new constellation of actors and instruments. As a matter of fact, the recent empowerment of the European Union in questions of financial regulation, accelerated by the financial crisis has started to shift competencies from nation states in the EU to the EU itself. The three new regulatory agencies, the European Banking Authority (EBA), the European Securities Market Authority (ESMA) and the European Insurance and Occupational Pension Authority (EIOPA) have powers, which by far outpace their predecessors which were mostly consultative bodies of national regulatory agencies. Therefore it is likely that European regulation will become more important, and national leeway will shrink. If this trend continues, future studies will have to inquire how information on practices of regulatory circumvention gained in national regulatory dialogues are transferred to the European level or if such dialogues are organized on the European level.

8.4 The future of the regulation of the bank-based shadow banking sector

In seeking to generate future regulation, what is important is not to only analyze the facts before the financial crisis, e.g. the configuration of the shadow banking system in 2006 in the US, but also to study it as a dynamic system and to seek to understand its source. This source is financial market regulation itself. Shadow banks are an outcome of “organizational engineering”, a form of financial engineering which applies the principles of ‘synthetic replication of contracts’ to organizational constructs to avoid costly regulation. The Financial Stability Board, which is the arm of the G20 responsible for developing new regulation has made the comprehensive regulation of the bank-based shadow banking sectors one of its most important goals (s. FSB

2011 a, b). Any possible solution to the problem of unruly off-balance sheet activities of banks to avoid costly regulation needs to solve two problems. On the one hand, it needs to take into account the fact that any future regulation will provoke further acts of regulatory circumvention. Rather than seeking to specify the content of activities that will be forbidden too narrowly, it should place power into the principles based judgment of banking regulators. While this is already an aspect of the Basle Accords since 2004, my study shows that this requires a deep knowledge of accounting as the field of production of the numbers regulators come to observe. Second, it needs to overcome the fear of ‘competitive inequities’ national regulators have with respect to their domestic banks. In the immediate aftermath of a cataclysmic financial crisis, these concerns are muted, but they will re-emerge in time.

There are several options to reduce the salience of this problem. One is to generate a global standard for consolidation (s. Financial Stability Forum 2008), something which could occur if the two most powerful standards setters , the International Accounting Standards Board and the Financial Accounting Standards Board of the US agree, but recent debates between the two standards setters have made this event look less likely²⁰⁵. This would leave regulators with two problems. First, there is the need for a common interpretation of this standard globally, which requires the enforcement of a common interpretation. Here, national banking regulators need to become active. The second one regards the quality of the standard and the possibility for circumvention. While the recent experiences with off-balance sheet financing should push standard setters into a more prudent direction, there is no guarantee that the new standard can actually achieve it. Thus, supervision of the accounting practices of banks from this prudential point of view needs to be forthcoming. So what is needed is a common interpretation of the

²⁰⁵ In the summer of 2012, the FASB chair Seidmann indicated at the IMA conference, that total convergence is off the table. S. <http://accountingonion.typepad.com/theaccountingonion/2012/07/what-the-resignation-of-james-kroeker-means-for-ifs-in-the-us.html>

standard, which is prudent/ strict. It is difficult to envision how such a common interpretation globally could be secured. Furthermore, the different risk regulatory regimes analyzed in chapter six point to the variation of enforcement, with the Netherlands being the starkest negative example.

The second possibility is to forbid foreign banks to operate according to their domestic regulation in the shadow banking system on foreign soil, thereby overcoming the competitive inequities connected with the national regulation of a global market at least on home soil. However, such regulation might be difficult to enforce and would violate for example European Union regulation on the liberalized banking market based on home country supervision. Therefore, this option requires major treaty changes and seems unlikely.

The third option is to disconnect the prudential treatment of shadow banks sponsored by banks completely from their accounting treatment and to agree globally that all such shadow banks should be included in the scope of prudential regulation. The Financial Stability Board is examining the prudential consolidation of all bank-based shadow banks, independent of their accounting treatment since September 2011. It is to be expected that if this decision were come to pass, the same dynamics observed in this study will reoccur at the margins of what does and what does not constitute a part of the shadow banking sector, and what does it mean to say bank-based. The problem will not be eliminated, but transferring it from the margins of the banking system to the margins of the shadow banking system might limit future damaging impact from this sector. But while international coordination, e.g. in the realm of Basel might mitigate these tensions, given the current impossibility for sanctions, the process might indeed be very slow or not forthcoming at all. The first or the third option might become a reality in the near future, but they will not entirely solve the problem in and of itself. They will require on the one hand, active

monitoring of the structuring activity of banks and their regulatory advisors to understand their attempts at regulatory circumvention. On the other hand, they will require monitoring of the enforcement of these rules in different countries, in order to establish the trust for national banking regulators that their banking conglomerates will not suffer from competitive inequities. In this respect, a larger degree of sanctioning power on the international level might be necessary, but it will have to be combined with efficient information gathering in national legislations.

In order to use such national information gathering efficiently and to reduce the time lag between acts of regulatory arbitrage and a global response, banking regulators should consider an institutional forum similar to the Interpretation Standard Committee of the IASB. National banking regulators should gather at the Basel Committee and debate recent fields and trends of regulatory arbitrage. They could then issue interpretations of the global banking rules which are currently evaded, seeking to make them robust to such attempts of circumvention.

8.5 The implications of this study for future research in the sociology of finance

The crisis has revealed the failure of the economics profession to predict behaviour in financial markets correctly. Indeed, the fact that so few of the profession had predicted the crisis has brought much immediate humbleness to the economics profession during the crisis. While it also stirred desires on the part of economic sociologists to provide an alternative explanatory framework, not many studies have been forthcoming in the past 5 years which could claim to be of policy relevance, giving directions for future regulation (a fact problematized in a symposium of some of the leading economic sociologists in 2009, s. Lounsboury and Hirsch 2010). This lack of policy relevance of its own work partially resides in the construction of its own subject matter,

where certain aspects are highlighted and analyzed (such as frameworks of valuation), but their interaction with the political forces active in shaping the market are neglected (for a similar critique towards institutional economics, s. Underhill 2007). There are indeed some economic sociologists, who are requesting the analysis of markets as mechanisms of exchange and their impact on distribution at the same time (s. Beckert 2009 a, b, Beckert and Streeck 2008). This study has sought to follow these requests and inquired into the shaping of the accounting framework that guides market exchange as the outcome of actions by market actors seeking to structure these markets to their advantage (s. Beckert 2009b: 20, s. also Beckert and Streeck 2008, Muegge 2010).

One analytical frame that has gained some traction in the analysis of the financial crisis in economic sociology has been the one of Normal Accidents (s. Guillen and Suarez, 2010), which emphasizes that the financial markets were highly complex and tightly coupled systems which had to break-down; a break-down initiated by a string of regulatory and organizational decision making. The scale of the crisis can only be understood by the fact that financial markets and the banking system were so closely interlinked. While this framework might function as a useful heuristic to imagine different architectures of financial systems less prone to crisis (s. Schneiberg and Bartley 2010), it is problematic regarding the suggested remedies, when coupled with a focus on individual agents (s. Guillen and Suarez 2010). The plea of Guillen and Suarez to reduce the coupling of the system, while maintaining financial innovations and thereby the complexity of the system overlooks the fact that financial innovations, such as the ABCP market were creating tighter coupling between markets. Thus, one cannot maintain the same degree of financial innovation and at the same time reduce the coupling between the different parts of the financial system.

Their analysis furthermore overlooks the fact that deviance, in the form of regulatory circumvention is systemic and that it expresses itself in form of financial innovations. It is systemic, because the pressure for highest possible profitability is systemic. As profitability is first and foremost a temporary assessment of a corporation at a given moment in time, increasing profitability includes the exploitation of legal frameworks to manipulate the balance sheets.

The sociologist who developed the theory of Normal Accidents, Perrow has pointed out (2010) that the financial crisis cannot be analyzed in the Normal Accident framework, as that framework was developed to describe situations where every actor is seeking to stabilize the system and prevent accidents from happening. In the case of the financial crisis, this was not the case as financial market actors sought to circumvent the rules. However, I have to disagree with Perrow's emphasis on key players who invented ideologies in order to justify their appropriations and who were actively exposing the system to danger fully knowing about these dangers. This, on the one hand, ascribes too much foresight to these agents. On the other hand, it underplays the importance of structural conditions and dynamics in the system which explain the development in financial markets before the crisis. These dynamics are not driven by agents, but by the systemic change in financial markets towards capital market domination.

Credit, especially in the US has become disintermediated and is often provided by the capital markets directly. In these markets, institutional investors have grown to exorbitant proportions and are making their decisions often based on financial accounting numbers, rather than the direct relationship banking, which often characterizes bank-based credit decisions. This has led to the rising importance of accounting numbers, which is why we see a higher demand for the legal manipulation of these numbers. Given this demand, a market for regulatory advisory services develops which provides measures for exploiting the legal frameworks to the fullest to

optimize the representation in capital markets. Banks, losing their interest margins in the traditional loan business reorient themselves to provide access to capital markets for their clients to increase profitability. While the study of interaction between regulators and the regulated concerning regulatory relief, as provided by Perrow, is helpful to understand the crisis-proneness of the system, we need to embed it in the systemic dimensions to grasp for example why regulators do accommodate the requests of the regulated.

One of the economic sociologists most aware of these changes, and the conditions imposed upon firms by agents in capital markets, such as stock-brokers is Ezra Zuckermann. In a recent contribution (2010), he pointed to the need for sociologists to appreciate the work of economists in order to engage in a policy debate with them. His proposal to gain policy relevance is to analyze markets and seek to identify the empirical mechanisms, which lead the predictions of financial economists, specifically the Efficient Market Hypothesis, to fail.²⁰⁶ The work of sociologists in this view is to detect the conditions in markets which actually prevent these mechanisms from working (e.g. when it is impossible to publicly expose one's beliefs by "putting one's money where one's mouth is" due to the impossibility to short certain assets (such as housing). It is ironic that Zuckermann condemns the Social Studies of Finance as an apolitical approach to financial markets, which cannot be of help to develop policy recommendations. It is ironic, because his own proposal involves sociologists in a project to make reality approach economic theory, which is the hallmark of performativity theory and its view on economics as a performative science. What Zuckermann has done is to supplement the (theorizing) economists

²⁰⁶ Finance theory and the efficient market hypothesis in particular are built on two mechanisms, learning in repeated interactions and activities of arbitrage, which closes the price differentials in different markets for similar products to zero (called the law of one price, s. Fama 1970, for an attempt to save the efficient market hypothesis s. Brown 2009). These models are built on full information and the capacity to signal one's belief in a current overvaluation in the market by shorting it (s. Zuckermann 2010: 368).

with the observing sociologists to bring economic reality closer to the assumptions of economic theory.

However, suggestions by economists and sociologists alike (such as Ezra Zuckermann), which are seeking to change the structure of current markets to permit learning and arbitrage are showing a lack of awareness of the flip-side of market arbitrage, regulatory arbitrage by the help of which financial actors seek to evade regulatory costs and market discipline. Accepting the proposition that financial markets are populated by rational actors means to accept that these will engage in regulatory arbitrage, which legally exploits all possible loop-holes. Such activities, however, will lead to information distortions in the market, and false information needs to lead to false decision-making.

The last line of defence for the defenders of the efficient market hypothesis has become that there are a few smart actors in the market, which can see through such acts of regulatory arbitrage and lead the market to a correct pricing via their arbitrage practices. Importantly, this means to drop the assumption that all market actors are rational, instead assuming that some are superior to others. Two questions immediately arise. The first one is a question of dynamics, in which not only market arbitrage, but also regulatory arbitrage is continually evolving. Why is there a guarantee that market arbitrageurs always catch up with regulatory arbitrageurs the moment acts of regulatory arbitrage are developed and employed? The temporality of the game rather suggests a time lag going from regulatory arbitrage to market arbitrage. The second and related question, which can be asked thanks to the relaxation of the assumption that all market actors are rational: why should we assume that the most intelligent people engage in market arbitrage rather than regulatory arbitrage?

When one looks at the organizational infrastructure employed for regulatory arbitrage, one cannot but question such an assumption. Which are the actors perpetually engaging in regulatory arbitrage, e.g. in the field of accounting? As this dissertation has shown, these are the largest financial organizations in the world (banking conglomerates), providing payments to those actors developing the newest and most beneficial regulatory arbitrages (auditing networks). Thus, regulatory arbitrage has as its addressee the most powerful corporations in finance, which provide large secure revenue streams for such activity. This fact makes the assumption that the smartest actors will engage in market arbitrage, rather than regulatory arbitrage look dubious. Now, if regulatory arbitrage cannot be excluded from financial markets, this will lead to information distortions, endangering crucial assumption underlying the Efficient Market Hypothesis. It furthermore implies that the market structure cannot be such as to allow the EMH to become true, unless regulatory arbitrage is forbidden. But it cannot be forbidden, as it operates on legal grounds. Models of imperfect information thus seem to more appropriately represent the conditions in financial markets, in which agents keep principals deliberately uninformed regarding certain states of the world. Accepting this state of the world, the time has come to propose a new definition of efficient markets, which does not equate efficiency with perfection. Instead, efficient markets in real life might be defined as those in which regulatory arbitrage is kept under sufficient control by state activity to not become endemic. While enabling market arbitrage is a regulatory goal worth pursuing, inhibiting regulatory arbitrage should be seen as more important. The new question sociologists then should seek to answer is how state agencies can be enabled to keep regulatory arbitrage under control.

I agree with Zuckermann that the apolitical nature of the Social Studies of Finance is a big problem for a policy-oriented sociology of financial markets. In contrast to his view

however, I think that this approach has provided us with valuable tools for understanding market dynamics. What is needed is to situate these theoretical tools, such as performativity and framing in the political-economic context in which they are actually operating. In my dissertation I have used these tools but shifted the focus from markets to conglomerates, the most important actors in markets rather than markets themselves (s. Fligstein 2001 for a similar approach to economic sociology) and the way they are constituted by performative acts of accounting. What I have added to this analysis is the question how conglomerates are seeking to shape the performative acts of accounting which constitute them (chapter four) and how they seek to shape the rules according to which the performative acts of accounting are performed (chapter five). I think at this juncture, it becomes important to link the constructivist approach of the social studies of finance with theories of organizational interest and how they express themselves nationally (s. e.g. Perrow 2002: 31).²⁰⁷

In my comparative case study, we can observe the different capacity of profit-seeking conglomerates in different states to participate in the making of regulation and to block negative regulations, which threaten their business models. With the globalization of financial markets, i.e. the capacity of conglomerates to operate globally, while under national regulation, the arguments for a less stringent regulation due to threats of unfair domestic competition from foreign competitors with lighter regulatory burdens has grown, favouring organizational interests. As this study has shown, this move in their favour does not need to go unchallenged

²⁰⁷ In his study of the development of American capitalism, Perrow focuses on the developments in corporate law, which made large scale conglomerates the predominant form of organization in the US in the late 19th century (s. also Roy 1997, Fligstein 2001). Perrow argues that the developments of these legal infrastructures were shaped by organizational interests at the time, i. e. by organizational elites which were standing to gain from these developments. The difference between Perrow's historical study and the current moment is that in his case, conglomerates were born in order to take advantage of the centralization of power and to limit the legal liability of parent companies (s. Strasser and Blumberg 2011: 8). In the current situation, these structures are well established and conglomerates interact with the legal framework which constitutes them as conglomerates to their advantage. Thus instead of requesting new legislation seeking greater powers, we also find them seeking to block legislation which limits their space of manoeuvre.

and regulators can counter these requests for lighter regulatory burdens. However, as became clear in chapter five and six, countering these requests requires close linkages with experts in the market, regulatory capabilities and capacities which instead of delegating supervision to private agents question directly the behaviour of conglomerates and their attempts of regulatory circumvention.

The comparative method in this way opens up a critical perspective, as it becomes evident that shadow banks did not have to remain in the shadows, but instead that it was due to blockages in the national and international system that they often did. The comparative method shows that matters can be organized differently and that regulators can hold powerful elites to account. Risks, such as those stemming from financial markets, do not emanate naturally, nor is their distribution arbitrary. Comparative, critical social studies of finance can help not only to discern the mechanisms by the help of which powerful elites seek to structure the distribution of upside and downside risks to their advantage. It can also help to show which capabilities regulators need to prevent that. I hope this study has made a contribution in these two respects.

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Appendix 1 : Glossary

ABCP: Asset-Backed Commercial Papers, short-term commercial papers backed by assets, most often asset-backed securities

ABS: Asset-Backed Securities, Securities whose pay-offs are generated by the underlying assets; ABCP

are a subset of ABS, as they are refinancing with short-term commercial paper

AFM: Autoriteit Financiële Markten, Dutch Financial Markets Regulator, founded on March 1st 2002

AMF: Autorité des Marchés Financiers, French Financial Markets Authority
(founded on 01.01.2003 , before COB)

ANC : Autorité Nationale de la Comptabilité, French Accounting Standards Setter
(since 01.01.2010, before C NC)

BaFin: Bundesanstalt fuer Finanzdienstleistung (German Financial Supervisor, founded on May 1st 2002)

BaKred : Bundesanstalt fuer das Kreditwesen (German Banking Supervisor from 1962-2002, now part of BaFin)

BCBS : Basel Committee on Banking Supervision

BmJ : Bundesministerium der Justiz (Federal Ministry of Justice, Germany)

BmF : Bundesministerium der Finanzen (Federal Ministry of Finance, Germany)

CB : Commission Bancaire, French Banking Supervisor

CEBS : Council of European Banking Supervisors, established since 2004, replaced by EBA in 2010

COB : Commission des Operations des Bourses, French Financial Markets Supervisor until 2003

CNC : Conseil National de la Comptabilité, French Accounting Standards Setter from 1947-2009

CRC : Conseil de la Réglementation Comptable, the organ of the CNC which passes accounting rules

DNB : De Nederlandsche Bank, Dutch Central Bank

DRSC : Deutsches Rechnungslegungs-Standards-Committee, German private accounting standard setting body

EBA : European Banking Authority, founded in November 2010

ECB: European Central Bank

EFMLG : European Financial Markets Lawyers Group

FASB: Financial Accounting Standards Board (US-accounting standards setter)

IAS : International Accounting Standards, the name of the standards issued by the IASC (until 2001)

IASB : International Accounting Standards Board, founded in 2001

IASC : International Accounting Standards Council, founded in 1973, replaced by IASB in 2001

IDW: Institut der deutschen Wirtschaftspruefer (German Auditors Association)

IFRS : International Financial Reporting Standards, the name of the Accounting Standards issued by

the IASB (since 2001)

IMF : International Monetary Fund

KwG : Kreditwesengesetz (German banking law)

NIVRA: Dutch Auditors Association

RJ : Raad vor de Jaaresverslaggeving (Dutch Accounting Standards Setter)

SIC 12 : Standard Interpretations Committee 12, the interpretation that changed IAS 27, such that

Special purpose entities could be forced on the balance sheet

SIV : Structured Investment Vehicles

S&P : Standards and Poors

SPE : Special Purpose Entities